January 2011

Outlook on **Fixed Income**

As we close the books on 2010 and look ahead to 2011, we are of two minds.

First, when we look back two years to the depths of the 2008 crisis, it is truly incredible how much better condition the financial markets appear today than most of us might have guessed. The majority of fixed income markets across the globe have posted solid absolute returns during this time period. In addition, the strong demand for new issuance has helped many private entities recapitalize weak balance sheets, placing them in much better financial shape than before. The worst fears of default and calamity appear to have passed, and a sense of normalcy and stability has returned.

However, we are concerned that we will still see some rough seas in 2011 in the fixed income markets. Specifically, we are wary of the continuing sovereign debt crisis in developed markets, particularly among European sovereigns and financials, and of the massive retail fund flows that have buoyed the fixed income markets.

Since the collapse of Lehman Brothers in 2008, investors have piled over $320 billion of assets into U.S. fixed income mutual funds, especially into those areas traditionally deemed to be “safe”—a figure that does not include money market funds or other global fixed income flows.[1] We believe that fear of the volatile equity markets has been the leading driver of flows into U.S. investment-grade funds and, in particular, into U.S. intermediate investment-grade corporate bonds. What is troubling about these enormous flows is that retail investors appear to have forgotten that “safe” short-to-intermediate, highly-rated AAA fixed income securities were at the epicenter of the last collapse. The desire of investors to hold securities that offered yield and that were perceived to be safe led spreads to collapse across the entire credit market. Some of the best examples of this were the record-low issuance rates obtained by Wal-Mart and Microsoft in October 2010.

So where do the markets go from here? Significantly, underlying economic conditions are on stronger footing than what bond market participants had previously assumed. Global nominal GDP is positive, the Consumer Price Index (CPI) is positive, and commodity prices are rising—as are, finally, the overall top-line revenues of public companies. This has led to a dramatic sell-off in fixed income markets over the last quarter, as interest rates have adjusted to these conditions. Technically, fund flows appear to be reversing as well. Fixed income markets experienced outflows in six of the last seven weeks of 2010. In total for the last seven weeks, there were $9.5 billion in outflows, as investors have begun to deploy assets into other markets, particularly U.S. and emerging-market equities.[1]

Additionally, the U.S. Federal Reserve embarked on its second round of quantitative easing, in which it is expected to increase its balance sheet with purchases of about $600 billion worth of new Treasury securities, from November 2010 to June 2011. We believe that one of the main consequences of the Fed’s action will be a rebalancing of retail portfolios towards equities, as the Fed’s actions further reduce the relative return prospects for U.S. fixed income markets. This combination of conditions does not bode well for the return prospects of the asset classes that have been dominated by individual investors. If the old adage “Don’t fight the Fed” proves true, we believe it is best to try to step out of the way and look for fixed income opportunities in areas that are either unaffected by, or likely to benefit from, the Fed’s actions.

The other paramount issue in our minds is the sovereign debt problems in the developed world—particularly in peripheral European countries and its financials sector. In 2008, the epicenter of the crisis was the U.S. housing market, and the response in the United States was both strong and swift. The centralized institutions in the United States were able to backstop the crisis and, through TARP and other policy measures, help the financials sector raise private capital.

While not all U.S. banks are healthy, and impairment certainly still exists, the United States has largely been able to satisfy the market’s immediate debt concerns. Europe, by contrast, has yet to convince investors that it is able to contain the contagion. The European Central Bank (ECB) has been putting together facilities, in a similar manner to the United States, in the hopes of buying time. However, due to a

lack of clear, central rules, the process has become ensnared in national political issues. Without a clear resolution, it is likely that "bond vigilantes" will continue to test how far Europe will go to finally backstop sovereign debt—and, ultimately, the financials sector, which holds much of the underlying bonds.

Despite these worries, we enter the new year with optimism. While not necessarily upbeat on all aspects of the fixed income markets, we do believe that the current environment and the dislocations that we continue to expect will provide significant opportunities for active managers. Indeed, the ability of nimble and flexible managers to back away from trouble and then re-engage when others panic can provide meaningful value. If we see a reversal in fund flows and more direct challenges by "bond vigilantes" in Europe, we believe that 2011 could be a terrific year for performance relative to peers and benchmarks, although absolute returns could be challenging.

U.S. Fixed Income

Currently, Lazard's U.S. Fixed Income team is positioned away from intermediate investment-grade corporate credit, and beginning to move away from the belly of the curve. This is due to the fund flows and government policy that have focused on these two areas, as illustrated by the historically tight intermediate corporate spread levels in the fourth quarter and the historically wide 10- to 30-year Treasury spreads. We will continue to closely monitor these technical factors and use any resulting volatility as a buying opportunity.

We also believe that corporate debt is relatively healthy from a credit perspective, although valuations in certain cases remain expensive. The resurgent economy has made much of the market more resilient, and we believe that the increasing aggregate demand should continue to support corporate revenues. We also believe we are likely to continue to see investors oscillating between fear and greed, and stand ready to tactically purchase securities that are under duress from selling pressure.

The team continues to find opportunities outside of the technically supported corporate sector. For example, municipal securities have been an interesting area of the market, as investors' concerns over municipal debt and potential defaults have provided opportunities in off-the-mainstream credit, for those equipped to appropriately analyze the credit risk. This holds true as well for other out-of-the-mainstream concepts, such as equipment trusts. And we still find opportunities in the Agency mortgage-backed securities (MBS) market, which continues to struggle with the non-homogeneity of housing performance and related consumer behavior.

U.S. High Yield Fixed Income

Mid-cap corporations in America are getting healthier, and benefiting from a wave of refinancing. Most financing problems have been resolved, while others have been delayed sufficiently, easing our concerns with this space. The market is seemingly far more comfortable with private-sector credit, as U.S. high yield—which represents a credit trade, not interest-rate risk—was one of the best-performing areas during the fourth quarter.

Our outlook for high yield for the first quarter of 2011 is quite bullish. In our opinion, high yield fundamentals will remain strong, with many companies showing top-line growth, rising free cash flow, and healthier balance sheets. Recent high yield fund flows have been bolstered by investors searching for yield, and we believe such flows are likely to continue. New issuance volume will likely remain robust on further debt refinancing and potential new leveraged buyout activity.

While, in the immediate term, our better-quality positioning may lag more-aggressive strategies, we believe that our approach captures the preponderance of high yield return while leaving the larger risks of the sector behind. Given the current economic backdrop, we believe the high yield space will continue to be a strong choice for investors.

Global Fixed Income

While market concerns are similar across most strategies, global markets offer a wider opportunity set within which to implement decisions and avoid troubled regions or sectors. Thus, we begin 2011 by avoiding large segments of the sovereign developed fixed income markets, particularly peripheral Europe and most financials, until we have more clarity on how debt issues will be resolved. We also remain defensive in our duration exposure due to concerns over interest-rate volatility.

We believe some of the best opportunities continue to be in commodity-based markets and sovereigns with healthy balance sheets. While there is currently a heightened sense of concern among many investors, and much of the negative news is already discounted, we do believe this will lead to interesting buying opportunities later in 2011. At some point, opportunities within the tumultuous European market will become somewhat clearer. It is currently tough for us to step into Spain or Greece, even with five-year credit default swap spreads at around 350 and 1050 basis points respectively, but, at some point, these may be historic buying opportunities.[2] We remain mindful of attractive levels to re-engage in such markets.

Our positioning going into 2011 is defensive, including an underweight exposure to long-maturity bonds. We plan on maintaining our exposure to shorter-maturity corporate bonds with a focus on corporations that have strong cash flow, favorable debt structures, and diverse global exposure. We will focus our country allocations toward positions in faster-growing, fundamentally resilient countries, and maintain an active overlay currency exposure as another area in which to potentially add value.

Municipals

While we believe that macroeconomic growth and state revenues will continue to improve in the United States during 2011, we do not feel that they will be at a pace typically associated with a robust recovery, and it is uncertain whether they will recover to pre-recession levels in the near term. We believe budget cuts will continue in an effort to close these gaps, but, while cost reductions thus far have been notable, they have not been significant enough to offset steep revenue declines.

Many of the challenges we face in 2011 are the same ones we saw in 2010, as unemployment, health care, and pension costs continue to stress budgets. Further, the lack of bond insurance, lack of confidence in ratings, and reduced broker-dealer capacity may drive risk premiums higher and reduce liquidity conditions further for weaker issuers. We are also mindful of the expiration (in fiscal year 2012) of the American Recovery and Reinvestment Act of 2009, along with expectations for lower property tax receipts, which may be an additional headwind for fiscal balance. Due to these conditions, we believe credit impairment and default disclosures will continue for credits categorized as non-essential, marginal, and/or poorly managed.

With these factors in mind, we currently hold a modestly short-to-neutral interest-rate risk exposure. We are focusing on investments in the 10-year maturity sector, emphasizing issues that are characterized by sound financial metrics, essentiality, and experienced financial management. Where appropriate, we are purchasing callable bonds.

Conclusion

While we are somewhat concerned about the prospects for the overall fixed income markets in 2011, we believe that opportunity exists for managers that are flexible and can tactically engage the market. Europe clearly is a risky proposition, but it could represent one of the best opportunities for returns later in the year. In our view, the ability to move away from benchmark exposures and focus on opportunities at a fundamental security level will be a key factor driving returns for 2011.

Notes

1 Source: BofA Merrill Lynch, as of December 31, 2010

2 Source: Bloomberg, as of December 31, 2010

Important Information

Originally published on January 6, 2010. Revised and republished on January 13, 2011.

Past performance is not a reliable indicator of future results.

An investment in bonds carries risk. If interest rates rise, bond prices usually decline. The longer a bond's maturity, the greater the impact a change in interest rates can have on its price. If you do not hold a bond until maturity, you may experience a gain or loss when you sell. Bonds also carry the risk of default, which is the risk that the issuer is unable to make further income and principal payments. Other risks, including inflation risk, call risk, and pre-payment risk, also apply. Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one's home market. The values of these securities may be affected by changes in currency rates, application of a country's specific tax laws, changes in government administration, and economic and monetary policy. High-yield securities (also referred to as "junk bonds") inherently have a higher degree of market risk, default risk, and credit risk.

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