April 2011

# Outlook on **Fixed Income**

The first quarter of 2011 was filled with unpredictable events that had the potential to significantly jolt the global economic recovery—including the earthquake, tsunami and nuclear crisis in Japan; the political upheaval in oil-rich Middle East and North Africa; the ongoing debt worries in peripheral Europe; and the threat posed by accelerating raw materials inflation to emerging market countries. Nonetheless, the financial markets continued to show resiliency despite these events, suggesting that there may in fact be more strength in the global recovery than many might have assumed. As we look ahead to the second quarter, we continue to believe that markets will be volatile and, while it is impossible to predict the next shocks, we believe we will see more unforeseen events that could challenge the mettle of investors.

Our main message through this period is that volatility and uncertainty, while by definition unsettling, may provide significant opportunities in the market. The rolling cycles of fear and panic, combined with the ability of investors to rapidly move large sums of dollars across the globe and across asset allocation buckets, means that opportunities will present themselves for disciplined managers who are flexible enough to take advantage of them.

The challenge lies in understanding the risk factors in the market, and determining where it is prudent to engage these risks by identifying which investments provide the appropriate upside return with limited downside. Several of the key issues on our radar screen include the U.S. Federal Reserve's exit strategy from the second round of quantitative easing (QE2); how the European Central Bank and European Union leaders address the debt situation within the region's peripheral countries and banking systems; and how recent events in Japan, North Africa, and the Arabian Gulf will impact global growth.

Being nimble, flexible—and able to transact in cash bonds—is a terrific way to pick up meaningful basis points of return for client portfolios. Many of the traditional competitors in the cash bond market were leveraged hedge funds or proprietary trading desks at investment banks; however, these players are having difficulty competing in today's market, given the higher cost of capital associated with reserve requirements and the lack of available credit for leverage. As many of the larger bond investors are focused on derivatives markets and areas where they can obtain large exposures, it is much easier for us to extract value in these off-the-run pockets of opportunity than it was prior to 2008, when capital flowed more freely.

## Global Fixed Income

One of the key characteristics of global fixed income markets is the wide array of differentiated market dynamics from which to choose in terms of interest rates, credit, and currency markets. While news stories tend to focus on market averages, global investors can take a more granular approach and analyze each market and security on its own merits.

Fears of rising inflation and budget deficits have the team concerned about debt levels in developed markets, particularly U.S. public or sovereign debt; however, despite these fears, U.S. credit markets are a relatively attractive opportunity. Interest rate differentials also appear to be a key forward driver, as interest rates in various countries react to their own specific concerns and issues. We see this as an attractive opportunity to engage in those countries that are attempting to get ahead of the inflation curve by raising rates.

Europe, which remains one of the major sources of volatility and uncertainty for the second quarter, also represents a potential opportunity. Despite all of the concerns related to debt in the region's peripheral countries and its banking system, the euro continues to gain versus the U.S. dollar. We need more clarity as to how the overall situation will resolve before taking any big positions, but we are monitoring the current levels for potentially interesting entry points.

The global opportunity set is often broadly viewed in regional- or sector-based buckets. However, simply considering the averages would blind one to the differences, for example, between healthy Scandinavian countries and debt-strapped peripheral European ones. There is also a high amount of differentiation within the emerging markets between those nations that are falling behind the inflation curve and those that are staying in front of it. Identifying and rotating through these different opportunity sets will provide managers with the ability to add value over the remainder of the year.

## U.S Fixed Income

### Investment Grade

Currently, the biggest domestic inflection risk in U.S. fixed income markets revolves around the Fed's quantitative easing program (QE), which is scheduled to begin winding down in June. Despite the rise in rates through the first quarter, our models and analysis continue to suggest that QE is keeping the yield curve steep by holding short- to-intermediate rates materially below where they would otherwise be.

Since the near-collapse of 2008, the Fed has aggressively utilized its balance sheet in an unprecedented manner to shore up both the U.S. financial system and economy. With both now on stronger footing, the general support for aggressive balance sheet intervention has naturally subsided. Aside from the obvious concerns revolving around yield curve reshaping, there is the open question as to whether the stability that has thus far been achieved can survive without the Fed's direct support. There is also uncertainty around the valuation effects that the elimination of the QE program may have on risk markets that have been indirectly sustained by excess liquidity and leverage.

Conversely, if the Fed unexpectedly decides to extend the program, there is concern over what speculative hot spots may develop as a result, and what fallout may be experienced from a possible recasting of inflation and sovereign risks. Given such uncertainty, we remain focused on specific investment positioning, as the probability of material mark-to-market dislocations is expected to be high.

At this juncture, we believe that the resurgent economy has made much of the market more resilient, and we expect aggregate demand to continue to support revenues. While we are overweighted toward risk assets, we are concerned with the valuation risk of specific securities that have disproportionally benefited from the unprecedented fund flows and government intervention. We remain underweighted in investment-grade corporates as a result of specific security valuations.

We continue to find relative value opportunities in areas of the market that we believe to be misunderstood or that are difficult to evaluate. Agency mortgage-backed securities (MBS) remain attractive on an individual security basis, as we are finding advantageous characteristics without having to pay an additional premium. Additionally, we are finding interesting opportunities in taxable municipal bonds and in low-volatility, high yield bonds. From a yield curve perspective, we continue to focus on deemphasizing exposure to the belly of the curve.

### Municipals

The fear and panic in the municipal space also provides opportunities for future returns. We fully agree that there is a likelihood of credit events this year, but we do not expect them to be material, relative to the overall size of the market. Additionally, we believe that many doomsayers fail to understand the rapidly changing environment in municipal debt. While we still have significant concerns for the space, we believe that the generally improving economic conditions and growth in the United States will lead to some upside surprises in tax collections, benefiting state and other municipal coffers. Further, many local governments have apparently begun to get serious about dealing with fiscal budget deficits. This does not mean that all of the challenges will be resolved, but it does mean that the situation on the ground may be better than the worst-case scenarios many are predicting (or fearing).

The opportunity for investors within the municipal space will lie in recognizing the need to recalibrate return expectations, performing in-depth credit analysis, and understanding that municipal bonds are not one homogenously traded market. At times, there are dominant themes in the market that will favor revenue bonds, general obligation bonds, or other state- or sector-specific securities. In today's market, however, the opportunities present themselves on a security-specific basis.

### High Yield

We believe that better-quality high yield corporate bonds will be a strong source of returns through the upcoming quarter. Corporate America continues to get healthier, as evidenced by the reality of the profit cycle, and many companies that had financial issues have used the past two years to recapitalize their balance sheets. High yield securities can provide a nice hedge in a potentially inflationary and rising-interest-rate environment. These securities tend to be more sensitive to credit concerns than to duration and generally outperform in a

rising-interest-rate environment, as the larger coupon helps to cushion price erosion. Additionally, inflation can be a positive for levered companies, as debt is paid back in cheaper dollars and companies can also generally gain pricing power, allowing them to pass on higher costs.

A further benefit, at this point in the cycle, for better-quality high yield securities, is that many good credits are offered cheaply within the context of the broader fixed income market—and, in times of instability, better-quality high yield securities tend to outperform. Given current conditions, an investment in BB-type credits can be a way to add incremental returns to a more traditional investment-grade allocation.

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