

October 2011

# Outlook on Fixed Income

As we head into the last quarter of 2011, we continue to experience significant volatility and pricing dislocations in many different fixed income markets around the world. The ongoing debt crisis in Europe appears, for now, to be a key issue for many investors, and is tied closely to concerns about a slowdown or a recession in parts of Europe that would considerably impact the global growth recovery story. In our view, concerns about the United States are also hurting confidence, and the discussions surrounding the debt ceiling and budget deficit issues could be a concern later this quarter as the Congressional “Super Committee” debate culminates in mid-November. For now, we have seen a sharp reversal in global commodity prices and a renewed focus and demand for U.S. dollar liquidity, which coincided with a sharp upturn in the U.S. dollar. We have also seen a reversal in interest rate policy across many emerging economies, from a tightening stance to a more accommodating one, in an effort to stimulate growth. We have seen this policy reversal in China, as well as Brazil and Turkey, which are two other prominent countries that have cut rates to spur growth.

## Flight to Safety and Insurance

In this environment, the most dramatic impact has been the flight to traditionally “safe-haven” assets in the fixed income market that provide insurance-like protection against potentially bad outcomes in risk markets. The desire to purchase insurance at any price seems to reflect market fears of a return to 2008. We see little else that could explain the decrease in 10-year U.S. Treasury yields from 2.74% in early August to 1.72% by late September, the Swiss franc’s increase of more than 15% relative to the euro from early July through mid-August (as investors moved significant assets across the border), or the resilience of Scandinavian currencies (such as the Danish krone).

## The Risk-off Trade

While fixed income markets provided strong returns throughout most of the third quarter, global events have caused a massive retreat from risk assets within fixed income. For example, the JPMorgan Corporate Emerging Markets Bond Index Composite declined 5.96% for September.<sup>1</sup> The sell-off appears to be directly tied to problems in Europe and general risk aversion, as emerging market issuers borrow three times as much from European banks as they do from U.S. and Japanese lenders.<sup>2</sup> Investors fear that it will be more difficult for these issuers to borrow funds until the Greek and other peripheral European debt issues are resolved. This is in contrast to many large-cap, high-quality U.S. and European corporate issuers, whose borrowing costs remain low.

## Key Questions for the Future

We face two main concerns as we enter the fourth quarter:

1. With U.S. interest rates at historical lows, is the United States in a bond bubble?
2. As potential sovereign impairment issues play out in Europe, is global financial systemic risk similar to that in 2008?

While we firmly believe that there are indeed pockets within fixed income markets that are exceedingly expensive, there remain significant return opportunities based on the gap between underlying fundamentals and current pricing in many segments of the market. Unlike 2007, when the majority of securities were priced to positive outcomes, we do not believe the current market is in a bubble. In addition, existing financial conditions are different than they were in 2008. While there is potential for additional impairment in specific areas of the financial market, we believe that the possibility of systemic risk similar to 2008 as a result of this additional impairment is limited.

## Potential Bubbles and Opportunities in the U.S. Bond Market

**With U.S. interest rates at historical lows, is the United States in a bond bubble?** The fear and greed cycle is alive and well in global markets and, as we move ahead, we are reminded that there remain few investments that truly provide reliable correlation benefits and protection when markets generally turn negative on risk. In times of peril that are marked by discontinuous outcomes, investors seek insurance-like assets to protect their capital. The most trusted source of insurance continues to be the U.S. Treasury market. Currently, our base case scenario for the U.S. economy going forward is that we are in a mid-cycle slowdown or, at worst, we may face a mild recession. Data on the U.S. economy, current inflation, and raw commodity demand are consistent with our base case scenario. The yield of less than 2.00% on 10-year U.S. Treasuries is not. Rather, it is consistent with a depression or deflation scenario. It is our belief that this yield reflects fear. When investors are unsettled, they seek insurance. And when desperate, they may pay almost any price. At this juncture, we believe that U.S. Treasury yields reflect a large amount of protection purchased. This was most evident in late September, when yields on 10-year U.S. Treasuries fell precipitously to 1.71% and then, as fears in the market ebbed, yields rebounded to almost 2.00%.

On the downside, this might suggest that bubble-like conditions are forming in U.S. Treasuries; but, on the upside, we believe that fear has created opportunity in many sound securities that have been tossed aside in the flight to protect capital. We see this in the high-yield space, where we continue to view non-distressed high-yield corporate bonds as one of the most attractive areas of the U.S. fixed income market. We believe much of the non-distressed high-yield market reflects companies with sound balance sheets, low funding needs for the next three to five years, and strong willingness or ability to pay back debt. As U.S. credit markets sold off during the third quarter, we saw some significant valuation shifts in the high-yield market. Many of the lower-rated and more marginal credits were shunned as investors focused on higher-quality, non-distressed paper with stronger balance sheets and sustainable business models. During the sell-off, these types of securities held much of their value and remain in neutral-to-positive performance territory year to date. Nominal U.S. GDP remains above the level set prior to the Lehman collapse and corporate profits remain resilient, which has created an opportunity to invest in good corporate credits at lower prices, in our view. In addition to the high-yield market, spreads have begun to widen in high-grade corporate bonds, which could be a good opportunity to selectively purchase quality names with better-than-average characteristics at bargain valuations.

Our analysis suggests that agency mortgage-backed securities also remain a rich environment for security selection. As we have stated in the past, many proprietary trading desks, hedge funds, and other leveraged traders seem to have exited these high-quality markets, allowing patient, analytical investors to take advantage of the opportunity to purchase securities with strong underlying loan attributes at attractive valuations.

## Is This 2008 All Over Again?

**As potential sovereign impairment issues play out in Europe, is global financial systemic risk similar to that in 2008?** We do not believe that the conditions that existed in 2008 will be repeated. Those conditions were unique because an over-levered global economy was surprised by significant global AAA-rated asset impairment. Subsequently, this led to a global liquidity crisis and, ultimately, culminated in a financial system breakdown. By contrast, the impairment risk confronting us today is localized and the impairment itself has yet to occur. In addition, the world's financial infrastructure has evolved since 2008 and has been adjusting to the potential impairment ahead of the event.

In our view, the main risk that we face is of a macroeconomic sort, primarily the European sovereign debt crisis and its potential economic fallout. We believe that many lessons were learned from the 2008 financial collapse and that, globally, action is being taken to prevent the type of unanticipated collateral damage that occurred with the Lehman Brothers bankruptcy. Comments from top European officials, such as German Chancellor Angela Merkel or European Central Bank officials, stating that a disorderly default of Greek debt is unacceptable inherently imply that an orderly default might be acceptable. We believe that much has been done to prepare for a potential sovereign default, as all the known and potentially stressed connections between sovereigns, banks, and Greece have been strengthened in order to ensure that ample liquidity and transparency is in place.

Risks remain in the region, and countries in Europe's periphery will likely remain under pressure until core Europe can provide true stabilization. This could be achieved through loan guarantees or additional funding for the European Financial Stability Facility. There are significant political hurdles in Europe, but we believe that Germany is committed to the euro, although we feel there is a high likelihood that Greece will default, as it appears that European policymakers are preparing for an orderly default or restructuring. In our view, the magnitude of the Greek problem is relatively small, and Greek bonds are already trading in the range of 30 to 50 cents on the dollar. We believe the more salient concern is the potential for contagion to larger countries, such as Spain and Italy, as well as contagion to the global banking system, which owns a large amount of sovereign debt.

Thus, we see considerable opportunity to tactically maneuver through parts of the global market that have been unfairly impacted by sovereign-debt issues in Europe. Rotation through the volatile currency markets to navigate risk-on and risk-off movements remains a key part of a tactical strategy, as this dispersion continues to generate opportunity. In addition, we believe corporate credits of large European multinationals could potentially provide some of the best opportunities, as many of these companies are, for the most part, fundamentally untethered from local markets.

## Summary

The focus for the quarter ahead, in our view, is on the compelling opportunities that dislocations and high levels of dispersion around expected returns or within benchmarks create for fundamentally-driven investors who are willing to buy out-of-favor securities. We believe that extreme market conditions and increased levels of volatility will persist through the balance of the year, as many of the key issues that are weighing on the markets have a long way to go before they are resolved. It is important to remember that interventionist governments and central bank policy continue to drive markets and asset pricing. These actions can be swift and unpredictable, and have the potential to dramatically impact the risk/reward profile of securities and currencies. We conclude that investors should be prepared to encounter unprecedented policy that cannot be modeled based on precedent.

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## Notes

1. Source: Bloomberg, as of 30 September 2011
2. Source: Merrill Lynch, as of 27 September 2011

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## Important Information

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Past performance is not a reliable indicator of future results.

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