

January 2012

Outlook on Fixed Income

The 2011 Review

As we look ahead for fixed income markets in 2012, it is useful to reflect on where markets were a year ago and review the investment flows that drove the performance results of 2011. As we entered 2011, the general consensus in fixed income was that developed market government securities were expensive, and that sovereign interest rates would likely rise due to increased financing needs and inflationary commodity pressures. Non-U.S. developed market sovereign credit risk appeared contained, while U.S. municipal markets were under intense pressure due to fears of impending bankruptcies across the country. Positioning based on these consensus assumptions, however, would have led to challenging results: the 10-year U.S. Treasury yield fell from 3.30% on December 31, 2010 to 1.88% by December 31, 2011; non-U.S. developed sovereign credit spreads widened exponentially; commodity prices remained contained; and U.S. municipal credit spreads compressed. Ultimately, U.S. municipal securities were the top-performing high-grade sector for 2011, returning 10.7%, while 10-year U.S. Treasuries were up 9.8%. Additionally, consensus assumptions regarding duration and curve positioning proved to be incorrect, as it was the long end of the curve that drove much of the results, particularly in government securities, as highlighted by the 20+ year U.S. Treasury Index return of 33.8%.

Fundamentals versus Technicals

Performance results in 2011 raised many questions, as the price action of many security classes showed a significant break from fundamental valuations. We believe that deconstructing and identifying the forces behind these incongruent market returns will be a key determinant of relative performance in 2012. In particular, we believe that understanding the forces behind the resiliency of the U.S. Treasury market is essential for investing in 2012. From a fundamental standpoint, the success of U.S. Treasuries in 2011 made little sense. If a fundamental investor believed that earning a 3.30% yield on a 10-year U.S. Treasury on January 1, 2011 was insufficient, how attractive does that security look today at a yield of less than 2.00%? Our episodal analysis leads us to conclude that the 10-year U.S. Treasury, based on concurrent U.S. economic conditions, should be trading much closer to prior levels. Unless there is significant capital destruction in the United States akin to the Great Depression, it is difficult to fundamentally reconcile U.S. Treasury yields at such low levels.

This leads us to further conclude that the behavior of U.S. government securities needs to be viewed through a different lens. We believe that the technical support of U.S. government securities is largely due to the fact that the basic tenets that have long supported global developed market investing have become unstable. Political discord has risen in global developed markets, the sovereign government policies in these markets are aggressive and unproven, and credit rating agency analysis remains, in our opinion, inconclusive at best. Until a stable investment paradigm for global sovereigns is reestablished, we expect U.S. Treasury markets to be driven by two factors. The first is by investors seeking safe harbor in the historical consistency of reserve currency payments from an empowered independent central bank. The second is by the general scarcity of such obligations, resulting from U.S. fiscal discord. We firmly believe that buying and owning 10-year Treasury securities at current prices is a losing proposition, as we believe an event akin to the Great Depression is already priced in. While market strength driven by such technical factors presents interim investment challenges, we believe that the resulting high level of uncertainty, volatility, and valuation dispersion has created extensive investment opportunities for longer-term investors, like ourselves, who focus on the fundamental drivers of both debt repayment and correlation.

Seeking Correlation Benefits and “Insurance”

Correlations between asset classes are at extremes today, as investors group assets into either risk-on or risk-off categories. The few remaining bastions of risk-off securities in 2011 were U.S. Treasuries, gold, the Swiss franc, German bunds, and U.K. gilts. These investments typically behaved as the safety valves to many of the key crises that happened throughout the year, although many of these “insurance vehicles” broke: the Swiss National Bank intervened in markets to peg the franc to the euro to ease pressure on the Swiss economy; slowing global growth lessened the inflation fears that had supported gold; and the ongoing European debt crisis burdened even the highest-quality sovereign bonds in Europe. While gilts and bunds have held up, the 5-year credit default swap rates (CDS) on the securities have widened significantly relative to U.S. Treasuries. This has left the U.S. market—and to some extent Japan, via the yen—as the main outlets for investors seeking a safe haven.

Similarly, while much of the consensus view of the U.S. dollar was negative due to inflationary fears and the U.S. Federal Reserve’s accommodative policy, positioning for this trade would again have produced negative results. The U.S. dollar appreciated versus the majority of G-10 currencies for the year (apart from the yen, which strengthened by 5.5% versus the dollar for 2011), particularly over the last six months of 2011. This behavior prompted investors to ask themselves whether the United States was actually ahead of the curve, as most other developed and emerging market nations were lowering rates and becoming more accommodative. Policy initiatives by the European Central Bank (ECB) are unarguably easing, and even approach quantitative easing. A large portion of the support for the euro has been tied to the interest rate differential, which has been near 100 basis points, with further ECB easing expected into 2012. Additionally, as inflationary fears have ebbed in emerging markets, central banks are becoming more accommodative and rates are dropping in most major emerging market countries in an effort to stimulate growth.

The Importance of Security Selection to Mitigate Macro Risks

While we do not know how long the already lengthy rally in U.S. Treasuries and other government safety trades will last, we do know from other asset classes, particularly currency markets, that technical factors can rapidly overwhelm fundamentals for extended periods of time. However, if one missed the macro story and the technical rally in securities that were considered risk-off, performance returns could potentially have been somewhat mitigated by strong security selection, in our opinion. We believe the environment for bond investing in 2012 is still quite challenging, as sovereign risks in developed markets remain, political discord continues, and confidence in ratings agencies is low. Investors will need to be particularly mindful of credit risks, impairment, and the many substandard securities that are still available, in our view. However, we believe there are still ample ways to secure excess returns without compromising fundamental valuation measures even if the insurance bid for safety persists in 2012.

U.S. Fixed Income

As noted above, one area of the market that did primarily reward fundamental factors was the municipal bond market. The across-the-board dire predictions for this category of securities in early 2011 created vast opportunity for investors that were able to identify the creditworthy obligors and securities within the universe. We believe investment opportunities will continue in 2012, as the municipal market is diverse, and securities that were previously thought of as commoditized appear to be trading on their individual merits and characteristics. Fundamental investors can find real value by understanding security-specific risks, such as financial soundness of issuer, terms and conditions of the security, essentiality, and other various factors that can impact the ability and willingness to repay debt. Municipals also offer a wide variety of securities across the risk spectrum, so a prudent investor can find value for even a traditional tax-exempt institutional mandate.

Security selection in individual U.S. Agency mortgage-backed securities (MBS) remains one of the more attractive investment areas, in our opinion. Investors can still find opportunity to extract value in this space, as many securities continue to be priced to an average. As such, we believe bonds with desirable characteristics are available at attractive valuations for prudent, fundamental investors. Mortgage pool characteristics that can be beneficial include geography, loan to value, vintage, servicer, and borrower credit quality.

As the easy money leverage that characterized the Great Moderation is no longer available, the bond market is slowly reverting to valuation paradigms that characterized markets prior to that period. As a result, some of the more analytically challenging segments of the market are also currently interesting. For example, many investors are backing away from structured and collateralized offerings that may hold a lot of value for those with patience and the appropriate analytical capacity. Often, these offerings are also smaller, causing many of the larger buyers to overlook them despite the opportunity. We believe we will continue to find opportunity in many of these less-explored segments of the market in 2012.

U.S. High Yield

Fundamentals within most of the better-quality high yield market remain strong, especially in industrials. For investors committed to the space, the BB/B non-distressed industrials sector in some ways may be thought of as representing the “Treasury market of U.S. high yield.” These are the companies that we believe investors want to own in difficult times, as they hold tangible assets that could be used to pay off debts if needed. In fact, many of these types of high yield companies posted higher revenues and cash flows in 2011 than in 2010, as well as raised their capital expenditure budgets. Rating agency upgrades continued to outpace downgrades by approximately 1.5 to 1.0 in the space, and default rates for 2012 are expected to rise modestly, but remain below their long-term average of 4.0%. Additionally, the much heralded wall of bank and bond maturities has been virtually leveled. High yield bank and bond maturities for 2012 and 2013 combined total about \$160 billion, considerably less than the \$215 billion in new high yield bond issuance in 2011. Most upper-tier high yield credits have strengthened their balance sheets, added liquidity, and pushed out their debt maturity schedules, which we believe should position them well to endure a slowing economic environment without additional financing.

Currently, high yield market spreads are approximately 700 basis points over Treasury rates. We believe spreads have the potential to narrow in 2012 by as much as 150 basis points, should high yield continue to produce an attractive current yield and investor demand escalates.

Global Fixed Income

Given the broad and diverse universe in the global fixed income markets, we continue to find opportunities away from the overvalued “insurance trades” discussed above. While the U.S. market is currently the main outlet for flights to safety, other AAA countries, such as Australia, New Zealand, Scandinavia, Canada, and the United Kingdom, remain attractive to us.

Avoiding peripheral Europe and most of the banks/financials in the Eurozone provides another opportunity within developed sovereign markets. These securities tend to be most directly associated with potential impairment, and generally appear to have a higher degree of risk associated with them. In addition, focusing on term structure is another important part of the strategy, as we can selectively engage in barbelled positioning in select markets, such as Australia, where the chance of more rate cuts are reflected and perhaps overly optimistic, in our view.

Important Information

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