

# QUARTERLY CIO ECONOMIC COMMENTARY

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CUTWATER ASSET MANAGEMENT

## The Nature of Economic and Financial Cycles

Welcome to Cutwater Asset Management's first quarterly investment outlook of 2010. I have been involved in the fixed income markets for over 25 years, acting in multiple capacities as portfolio manager, trader, treasurer and analyst. I have focused on areas such as MBS, ABS, Corporates and Government debt in both cash and derivative markets servicing a host of clients around the world. To say the least, my team and I have seen a lot over this time and space continuum. What we've learned – and we have learned much over those years – is that despite efforts to eradicate the economic cycle through creative applications of fiscal and monetary policy and regulation, the economic and investment cycle does (in fact it must) exist. 2008 and 2009 evidenced that result writ large.

I fear, despite current efforts to re-regulate, legislate, and jaw-bone the financial system so this "never happens again," we are fooling ourselves much like how Wile E. Coyote never learns that no matter what new technology Acme Corp. puts at his disposal (the rocket skates were my favorite), he ultimately winds up shooting over the cliff and hovers for a few seconds, not knowing until it's too late, that he overshot his target, and well, you know the rest...poof! It is his *animal spirits* that inevitably cause him to lose sight of the fundamentals (there is no land beneath him!). It is those same animal spirits that drive our markets and inform the investment cycle.

Similarly, attempts at erasing economic and investment cycles are difficult as well because the "Bell Curve" of investing is not based upon physical sciences, but rather on more difficult measurements produced by human judgments, emotions, biases and the animal spirits of "Fear" and "Greed" which represent the tails of investment distributions.

This "human condition" is not only hard to measure, it is difficult to legislate or regulate away, so while we should seek improvements to some of the more obvious problems that have plagued this round of outsized volatility,

we should not fool ourselves that the economic and investment cycle will be relegated to the scrap heap of history. In fact, one might argue that the "rocket skates" provided by an easing Fed combined with copious amounts of fiscal stimulus could propel our economy over a cliff sometime down the road. That said, from our perspective as an investor, these cycles and movements form the basis of our investment opportunities and alert us to investment risks as greed begins to build and prices overshoot the fundamentals.

I speak of this in our first letter of 2010 to provide you with a feel for the way we think about markets and investment opportunities. We tend to take a thoughtful and long-term view on how to maximize the return on and of your capital. Taking a longer-term view allows us a critical advantage of perspective on valuation and risk and helps us avoid the pitfalls of the typical "pro-cyclical" asset management machine that pressures managers to seek short-term performance at the expense of optimizing longer-term returns. Importantly no matter what the mood of the market is, we never take our eye off of the fundamentals and where we sit in the cycle between the extremes of fear and greed.

It is in these Core investment principles that we found the inspiration for our new name, Cutwater Asset Management. A cutwater is the stainless steel strap of metal at the bow of a boat; as its name implies, despite currents and waves that may slap at the hull, the Cutwater slices through, keeping the bow pointed toward the ultimate destination. So, with our Cutwater guiding us to very strong investment performance in the turbulent waters of 2008 and 2009, and as we perhaps move into calmer waters, we offer our insights into what we see in store for fixed income investors in 2010.

As we begin 2010 and discuss some of the key trends we expect to see this year, it is useful to take a brief look back at the tumultuous years of 2008-2009. The fear of a near collapse of the financial system in 2008 created major policy responses, both fiscal and monetary,

applied to prevent a second Great Depression. Some of these policies and programs began in 2008 and accelerated or were expanded in 2009, such as the \$750 billion stimulus package and programs like the Troubled Asset Relief Program (TARP). These fiscal responses were matched by equally massive monetary responses. The Fed also devised a set of aggressive policies such as moving the Fed Funds Rate to zero. It also employed massive quantitative easing strategies to support our wobbly debt markets. While the policies in reality have somewhat mixed political and long-term economic implications, Cutwater believes that for the most part these actions were necessary moves to help calm the waves of panic that were the psychological drivers behind the near implosion of the financial markets. Whether good long-term policy or not, these draconian efforts produced the necessary calm to prevent total panic and systemic financial collapse.

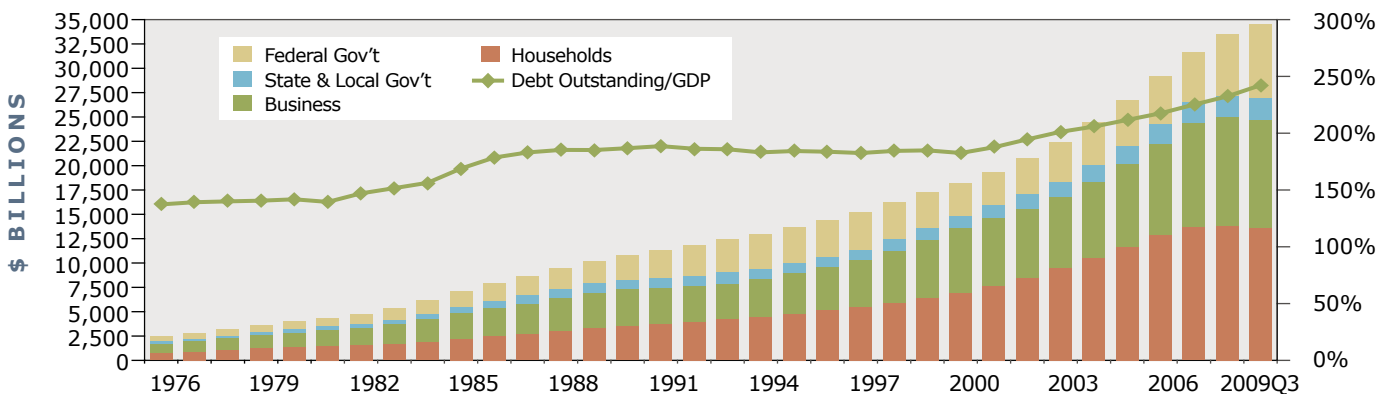
In many ways, the short-term fix was successful and served as the “rocket skates” that propelled the rebound. The economy is recovering and the major components of the securities markets rebounded strongly. In 2009, the Dow was up 19 percent, the S&P 500 was up 24 percent and the NASDAQ had increased by 44 percent. In the fixed income world, the Barclay’s Capital Aggregate Bond Index was up by close to 6 percent at year-end, while riskier markets such as high yield bonds were up by 58% (a record performance)! Other aspects of the economy were stabilized by government policies as well. The stimulus plan, along with other programs such as the popular “cash for clunkers” and the first-time homebuyer’s tax credit, helped bring GDP growth into positive territory in the third and fourth quarters after a full year of rather large contractions, with a particularly painful drop occurring

in the first quarter. Consumer fundamentals are still rather weak but consumer sentiment has climbed from its nadir earlier in the year. We avoided the worst but still had to climb out of what is now referred to as the Great Recession. Unfortunately, the conversation was already shifting as we ended 2009 with concerns over our ballooning Federal debt load and abnormally high unemployment.

So where does this leave us as we move into 2010? The so-called Minsky moment, wherein investor panic culminates in freezes in credit and liquidity, appears to be over. We do expect the economy to continue to recover this year, albeit slowly after a quarter or two of inventory rebuilding which would serve to temporarily push GDP above longer-term trends. Why do we say this? Fundamentally, we like to look at the basic formula that drives our GDP which is composed of consumer spending plus business and government spending plus net exports. With 70% of GDP driven by a still over-levered and under-employed consumer, this “double whammy” likely keeps consumer spending below long-term levels for some time and certainly through 2010. In the short-term, government spending has largely compensated for consumer shortfalls, but clearly that is not a sustainable substitute. Debt fueled buying by the consumer has simply been shifted to Government and Fed balance sheets. In fact, U.S. household and non-financial business debt has barely decreased from its bubble peak and total debt (including Government debt) remains on the rise. In fact, aggregate non-financial debt now represents an eye-popping 250% of GDP. This is a level approximately 60 percentage points higher than long-term averages and ultimately payback could weigh on growth for years to come.

**Debt load as a percentage of GDP is high and growing.**

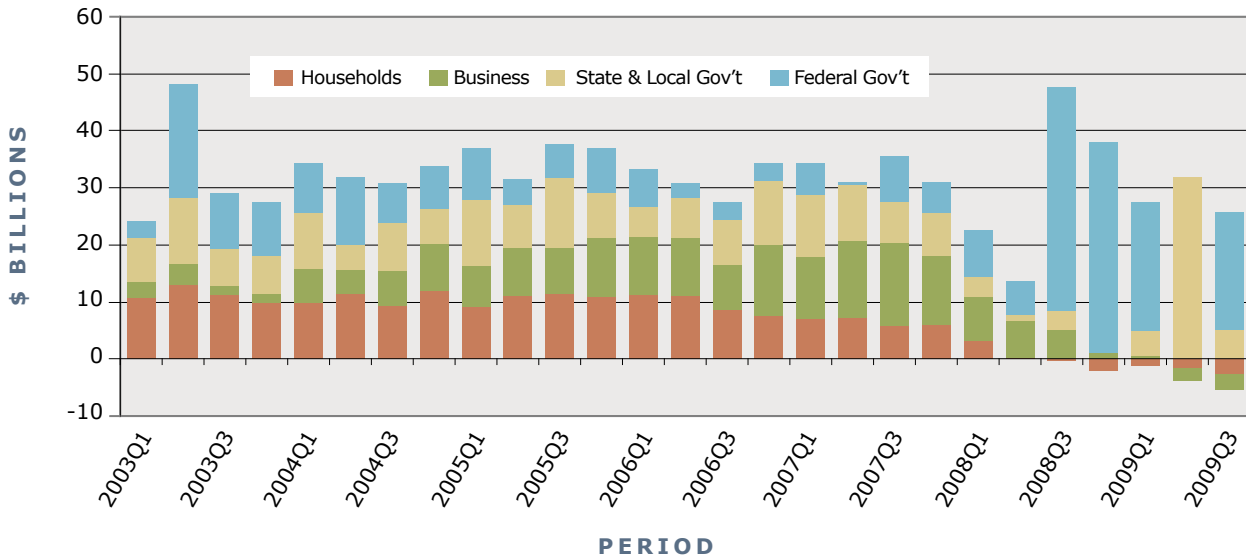
*Composition on Nonfinancial Debt Outstanding*



Source: Bureau of Economic Analysis and Federal Reserve Flow of Funds Report

**Federal debt explodes, which is likely to pressure rates.**

*Incremental Nonfinancial Debt Outstanding by Sector*



Source: Federal Reserve Flow of Funds Report

The Obama administration may gin up yet another stimulus plan aimed more at small businesses with the hope that growth can pick up momentum and be solidly and independently supported by the market. With this debt load weighing on our economy, we believe GDP growth will be 1 percent below the long-term trend, resting between 2 and 2.5 percent in 2010. The consensus view is that GDP growth needs to be above 3 percent in order for the employment rate to stabilize; therefore, we may see the official unemployment rate stay elevated for some time creating a drag on growth.

On the bright side for investors, slow growth can be productive for the bond market and spread products. More deliberate and stable growth vs. boom or bust periods of volatility generally translate into a stronger credit profile for corporate America as balance sheet strength/repair rises in priority. As such, while Cutwater believes that bond spreads will be subject to bouts of volatility, they likely grind tighter and therefore still represent sound value for our portfolios.

Furthermore, as the year progresses and as the economy grows, we see the Fed beginning to rescind its zero percent interest rate policy. History and logic would argue that we will witness higher rates not only in the short end, but all along the maturity spectrum. Indeed, we may well see the 10-year note move up from 3.5%

to 4.5% and with the steepest yield curve in a generation and huge deficits a concern, we believe that the Fed should move sooner to “flatten” the curve; i.e. raising short rates would create fewer fears over inflation than would a “lazy” increase in the Fed Funds Rate. Consequently, we have pointed our bow toward shorter maturities and durations in our portfolios.

In terms of our view of the non-treasury sectors of the bond market, we find solid value in corporates and high yield where spreads remain attractive. High yield has certainly rallied sharply but from a fundamental perspective credit spreads still imply a default rate in excess of 40% over a five-year period. We think this is too high and agree with Moody’s baseline expectation for five-year cumulative defaults to peak at 25% over the same period. Therefore we believe current spreads adequately compensate investors for the default risk but do caution to expect short-term pricing volatility. Conversely, among the overpriced sectors, we are avoiding Agency MBS. The Fed purchased virtually all the net MBS supply last year and drove spreads inside long-term historic levels vs. treasuries. This is one of the few sectors *overpriced* vs. long-term averages.

With a bloated balance sheet of negatively convex agency MBS in the face of a rising rate market, the Fed is expected to pull back from this market in 2010;

therefore we look for wider spreads to erode the prices of MBS during 2010. Conversely, we see unique opportunities in the asset-backed securities (ABS) sector. We expect that the ABS market will continue to repair itself and climb back from its historic lows. Although its reputation has taken a large hit, it should be remembered that at its peak the ABS market provided an amount of consumer and business financing equal to that of the banking market.

While over-engineered ABS products (such as CDO-squared) are gone for the foreseeable future, the broader ABS market is an important one that we believe will find growing support through further federal programs, continuing economic improvement and further calming of capital markets. This recovery should bode well for spreads in that sector in areas such as autos, credit cards and CLOs.

We are also going to keep a close eye on the Fed and other government policies. Further financial regulation appears to be looming, although it is not clear what form it will take. If new regulation is smart and targeted, it may be beneficial for the industry and the markets. If it is too constraining and burdensome, it will have a negative effect at a time when the markets do not need any more bad news. Again, we caution that animal spirits of markets are hard to cure.

In all, though, we are confident that economically 2010 will, in sum, be a better year than those of the recent past. However, it will still be marked by uncertainty and may even take a step or two backwards before we make strong strides forward. So, with these thoughts we keep the Cutwater solidly pointed toward the less turbulent waters of 2010. ■

## Fed Balance Sheet doubles driven by purchase of non Treasury assets

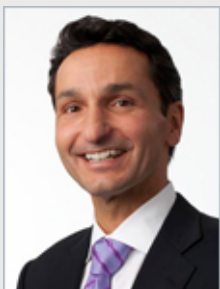
### Federal Reserve Balance Sheet

	Panic 9/17/2008	Current 1/27/2010	% Change
Gold, SDRs & Coins	\$14,705	\$18,467	
U.S. Treasury securities	\$479,839	\$776,619	
Federal agency debt securities	-	\$163,673	Fed balance sheet balloons to support troubled markets
Mortgage-backed securities	-	\$969,728	
AIG related	\$29,367	\$89,859	
Liquidity and credit facilities	\$333,294	\$135,267	
Other	\$139,320	\$96,551	
<b>Total Assets</b>	<b>\$996,525</b>	<b>\$2,250,164</b>	<b>126%</b>

Price-sensitive asset holdings also a concern

Source: Federal Reserve

## ABOUT THE AUTHOR



Clifford D. (Cliff) Corso is President and CIO of Cutwater Asset Management, a fixed-income investment management firm with a distinct focus on the long view. With over 25 years in the industry, Cliff directs the investment of over \$42 billion in assets belonging to state and local governments, sovereign governments, pension funds and large institutional investors. Throughout his career, he has managed a wide array of fixed income products, including corporate, asset-backed, government, mortgage and derivative products. Cliff received his bachelor's degree from Yale University and a master's degree from Columbia University. He holds his Series 7, 24, and 63 licenses from the Financial Industry Regulatory Authority (FINRA). For more information, visit [www.cutwater.com](http://www.cutwater.com).