

keynes is dead; the bond market vigilantes killed him off

You may recall the common parental refrain from early childhood when you sought too much of a “good thing,” like, say, too much candy? “You are going get sick if you eat any more!” So it is for the “sick men of Europe” now famously known as the PIIGS (pun intended-- Portugal, Ireland, Italy, Greece and Spain). After years of gorging at the Keynesian fiscal trough, the stomach churning result is finally at hand. The PIIG’s debt to gross domestic product (GDP) ratio is now north of 100%. In fact for Greece, some are now questioning its ability to stay solvent. Unfortunately, the sickness and nausea from Europe spread to the rest of the globe, culminating in a mass sell-off of risk assets during the second quarter. After a strong first quarter of risk-taking, the macro backdrop became the investment focus as sovereign risk became a “mini black swan.”

Fear over European defaults swept through the markets creating a systematic run on European bonds, with Greek sovereign yields reaching north of 10%, or junk levels. The Euro situation raised potential implications for slowing global growth and was the proximate cause for the systemic risk reduction trade. This, combined with weakening economic data in the U.S., along with the calamitous oil spill in the Gulf of Mexico, was too much for markets to stomach given the recent bouts of volatility. In general, we think the markets have leaned too far toward the fear side given our belief of an admittedly slowing, but still growing global economy (more on that later).

As for our portfolio results, we at Cutwater held our own through the tumult with our core and core plus bond portfolios reporting solid positive returns year-to-date. What worked and what didn’t? On the plus side, we had no Euro currency exposure in our portfolios and generally were rotating to lower “Beta,” or risk, in credit sectors.

Our foresight benefitted Cutwater clients. As we warned in our last Quarterly CIO Letter, many sectors of the bond market had come too far too fast and we began to rotate our portfolios away from higher Beta sectors. This paid dividends as spreads in virtually all bond sectors widened. We did lose some ground by being shorter in duration than the index given our own fears over growing U.S. debts and deficits (a piper we still believe will need to be paid through higher rates in the not too distant future). That said, the palpable systemic fear that spread through the global system sought refuge in U.S. Treasuries. This flight to quality caused a 50 basis point rally in Treasuries with the long end of the yield curve returning a significant 15% for the quarter versus the Barclay’s Capital Aggregate Bond Index, which was up 3.49%. Now, with 2-year and 10-year rates near historic lows (at 0.60% and 2.96% respectively) we remain comfortable that once the “fear” subsides, we will stand to gain from our short position as rates gravitate back to a more normal level consistent with economic growth.

SO, WHERE ARE WE HEADED FROM HERE?

My reference to Keynes holds some clues. Recall that Keynesian theory posits that governments should spend money during downturns to perform as an economic “shock absorber” to smooth out cycles and provide a bridge to the period when the economy gets back on its own two feet. At that point the government then theoretically should drastically reverse spending. The U.S. government is currently following the former tenet of Keynesian economics writ large here (recall that my previous CIO letter referred to the current huge fiscal stimuli as “rocket powered skates by Acme Corp”). Here’s the rub: too much of a “good thing” has occurred, primarily because politics inherently dissuades from pulling back the fiscal candy bowl when the economy ultimately comes back. Hence, higher and higher “structural debt” gets piled on government balance sheets without the requisite political will to do anything but kick the fiscal can down the road. Europe does not (actually cannot) stomach any more of the “good thing” of fiscal stimulus. The debt-to-GDP ratio is already too high in the Euro zone and finally the bond market vigilantes forced Europe’s hand by threatening a buyers’ strike for Euro sovereign debt. This forced a now familiar systemic response – a new government backed “rescue fund” of € 750 billion. As a result, fiscal constraint in Europe is here. Note, I didn’t use the word “austerity,” which is too strong a description for the proposed fiscal packages described (e.g. is retiring at age 62 vs. 60 really austerity?) Fiscal restraint in Europe is on the horizon as the bond market “offed” Keynes in the process. Slower growth in Europe will be a consequence, with a consensus forecast of approximately 1.5% Euro zone GDP growth in 2011.

That said, we are still constructive on our outlook for global GDP growth, which is forecasted at 4.5% next year. We view the biggest risk as a psychological one – fear itself, causing undue caution by consumers and businesses. We think this fear can be tamed. Our belief is that the European stability package, combined with the stress testing of the Euro banks (both techniques borrowed from the U.S. playbook), will go a long way toward reversing some of the panic and systematic fears that spooked the global stock and bond markets during the second quarter.

And, what should we make of the talk of a “double dip” recession? We don’t see that playing out. While recent economic data have downshifted a bit; the numbers are still showing growth. The work week is up, manufacturing continues to expand, business profits are solid, and corporations hold significant cash on hand awaiting investment. No doubt the large debt bubble we still have to work our way out of will take time (years – see chart on next page) and so we are not surprised by a downshift from 5.6% GDP growth in the fourth quarter of 2009 to a more understandably slower 2.7% figure in the first quarter of this year.

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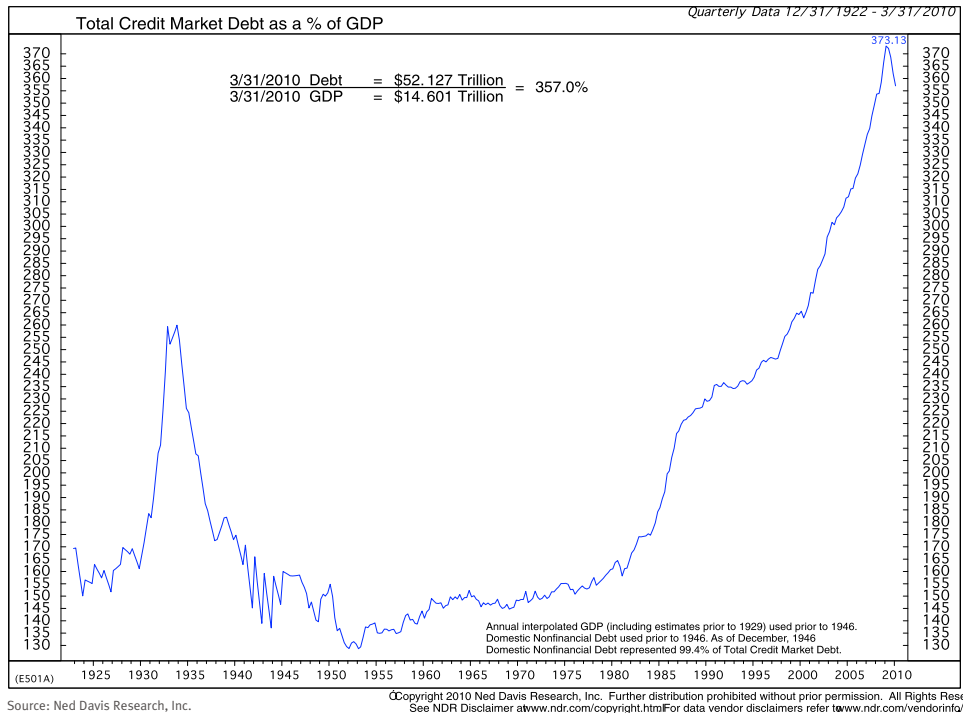
Indeed, we stick with our view of a “check mark” like recovery for the U.S. with slower 2.25% to 2.75% GDP figures for 2010 and 2011 (slightly below consensus due to the amount of leverage still in our system – see above). This downshift in growth, but at a level above 2%, is still a potential positive scenario for the risk sectors of the bond market and certainly so for some of the subsectors currently priced for a hard landing.

CONCLUSION

In sum, and in keeping with Cutwater’s investment philosophy wherein we take a long term view of bond market opportunities, we believe we are in phase three of a four phase cycle. Phase one was the blowout of 2008/2009, where risk shedding was overdone, providing us with a significant overweight opportunity in bond risk assets. Phase two was the rebound, which saw the large correction in spreads through the first quarter of 2010 where some sectors were then overdone (see my CIO letter for Q1 referencing way over priced CCCs!). Phase three, the current phase, is a period we expect will be marked by extended volatility. Given continued uncertainties surrounding the macro environment (like we witnessed in Europe) and the regulatory environment in the U.S., we believe that market volatility will continue to be a theme for the next 12 to 18 months. Remember, markets hate uncertainty. However, we remain constructive on spread assets given our overall view of a recovering economy and abating uncertainties (e.g. regulatory reform may be inefficient but at least we can soon remove this uncertainty and deal with the outcome). We view bouts of volatility as opportunities to add yield to the portfolio when fear rises too high, prices drop too low and the “margin for safety” of investing in spread assets grows. We will continue to set up our portfolios to operate in a more volatile environment during phase 3

and ultimately position for phase 4, where we envision a period of stability as we evolve out of this generational downturn and toward more predictable growth.

With a tumultuous 6 months now in the rearview mirror, we keep Cutwater’s bow cutting through the chop of macro uncertainty with continued overweights in certain spread sectors, such as corporates and select ABS positions, and expect to remain nimble enough to capitalize on the opportunities that volatility can bring. In keeping with Cutwater philosophy of taking the long view, we do foresee fears in the market eventually abating and the flight to quality deflating, whereby rates will then rise higher than they are today – perhaps we need watch out for our own “mini black swan” of higher rates. Stay tuned.



about the author



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