QUARTERLY CIO ECONOMIC COMMENTARY

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Monetary and Fiscal Rocket Fuel Propel Returns Skyward for Bonds

In our first quarter CIO letter, we discussed the copious amounts of monetary and fiscal stimulus sloshing around our financial system — $1 trillion plus from the Fed combined with a zero fed funds rate as well as a $1.4 trillion Federal spending deficit (a record). All this, and programs such as the Troubled Asset Relief Program (TARP), created "rocket powered skates from Acme Corp." as a metaphor for support for a rally in spreads. We cautioned, however, that one needs to consider the longer term impacts of the rocket fuel and focus on the fundamentals in the overall analysis of allocating money to the bond market. Our view was that in the short term, this fuel would continue to power spreads tighter, particularly in the ABS and CMBS sectors, which were still suffering from varying degrees of buyer's strike, given the savaging that sector experienced during the downturn. We also cautioned that as the economy repaired itself, the extraordinary stimulus left unchecked would lead toward higher rates. For the most part this is what played out during the first quarter as the overall Barclay's Aggregate Bond Index returned a respectable 1.78 percent. Thankfully, we were on the right side with most of our views, however the acceleration of spread compression catches us a little by surprise.

Q1 2010 Review

Why have spreads performed so strongly? Spreads across many sectors continued to compress as the economic data (supported by stimulus) continued to improve. In fact, the economic and earnings data came in stronger than what most had forecasted (including us). Thus far, the "New Normal" of slower growth caused by an over-levered consumer (two thirds of economic activity) has not played to script, given that fourth quarter GDP growth was 5.6 percent, and many have been calling for a similar GDP print for the first quarter of 2010. The positive data includes the return of consumer spending, strong service sector growth, a jump in manufacturing data and a pickup in our exports. In fact, in our view, these economic results have resulted in a "hockey stick" pattern of increasing risk appetite with more and more indiscriminate demand for "beta" in spread products across the bond market. So much so, that some sectors are actually now "rich" compared to long term historical norms (such as high quality industrials). By far, the standout sector for the quarter was CMBS which left all else in the dust with a 9.1 percent return for the quarter! Nothing else even came close. The next best bet was in lower quality corporates where BBBs produced a return just shy of 3.5 percent. Our view on ABS also played out as that sector outperformed the overall index despite its shorter duration profile. As for MBS, that sector underperformed the index slightly, however not nearly as much as we expect it will going forward, particularly since the Fed has ended its historic purchase program this quarter. Finally, rates began to move up slightly after much intra-quarter volatility, a reaction to stronger economic data.

Key Themes to Watch

So, with the market "loving risk" and the economy apparently out of the woods with regard to a "double dip," where do we see the economy and markets heading in the second quarter and beyond, and what does that portend for our portfolio strategies? We believe there are three key themes to watch going forward.

1. First, look for a market shift away from "beta" or the systemic ride to tighter spreads, which is running out of gas, toward a more bond and subsector specific "idiosyncratic" approach to capital allocation.
2. Second, we suspect a growing realization that higher rates may be here sooner rather than later and that the Fed may risk being behind the curve, thus spooking the long end of the yield curve and raising the specter of the bond vigilantes (see our March 8th market update for further commentary on why we believe the Fed should be more proactive in raising rates).
3. Third, there is concern over price erosion as rates rise down the road, driving a shift toward securities that provide some level of rate/inflation protection.

On the first point, simply put, we believe the "beta ride" is nearly over. The market is now entering a phase where we shift from the "easier money" of riding the crisis level systemic cheapness of spreads into much tighter levels to a phase where "idiosyncratic" risk provides the key opportunity for solid returns. As my earlier CIO outlook warned, some of this rocket fuel has propelled certain sectors to beyond fair value and over the "cliff" of fundamental support. For instance, this accelerated risk appetite has pushed CCC junk spreads down to 800 basis points spread from a wide of 3,000 basis points and inside the long-term mean of 1,000 basis points. At current spread levels there is very little cushion for expected default rates over the next few years. For example, taking a consensus view of the 5-year default rate for CCCs of 50 percent (Moody's), the "breakeven implied default rate" implied by current spreads is about 50 percent. To say the least, the fundamental underpinnings of this allocation are not as compelling as they once were. Conversely, we believe that there are still pockets of value in select ABS subsectors, such as subordinate cards (carefully underwritten), CMBS (despite the powerful rally, the sector is still attractive), and select finance names (profits are growing and losses shrinking).

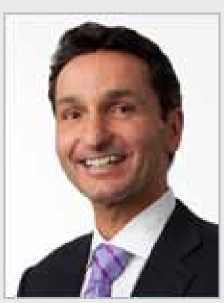
Our second forecast trend is a growing realization that the Fed may need to be more proactive as the economy improves. The Fed dropped the Funds rate to zero as an emergency measure to avoid a second Great Depression. Job accomplished — it is time to take the Great Depression cushion away or risk the market beginning to fear too slow a rate rise policy as we move forward. I suspect that Dr. Bernanke would like to make a move but is concerned about the market's potential overreaction. In a way, he is caught between a rock and a hard place. It's as if he is at the floor of the Grand Canyon on rates; he knows he can't stay there too long given the potential heat but his only means back to the top is to ride a jittery war torn donkey ("the market") up the treacherous slope of the canyon toward higher "normalized" rates. Tricky psychological business and we wish Dr. Bernanke well. Our advice: whip the donkey early with an early rate adjustment to re-establish that there will be control on the ride back toward higher rates. Just do so with clear language that the first step is a removal of emergency easing no longer needed. This should help quell concerns at the intermediate and long end of the curve where the bulk of consumer and business borrowing is pegged.

Despite this short-term advice, we do believe that we are destined toward higher rates as we move beyond this year into a secular rate rise regime. The market seems to think the rate rise is a one round boxing match with the Fed ending the bout with a knockout punch of a string of rate increases. We think the rate regime shift is a multi-round match with at least two stiff jabs and a hard right cross. The first jab is indeed the Fed — it must raise rates soon. The second jab is the treasury supply tsunami that we face over the next several years. If forecasts and borrowing trends hold at current pace, our Federal debt will soon be about 100 percent of GDP compared to about 60 percent today. This is just about where the "PIIG" countries (Portugal, Ireland, Italy, and Greece) are today and we see the turmoil that has occurred there. This is a stiff jab that must be parried by less spending and better investment decisions at the government level. The "right cross" is something we are not yet hearing much about, and that is the level of real yields. The real yield on 10-year bonds is only 1.5 percent, which is materially below long term averages of about 3 percent. What does this say about where our economy is headed? If over the long haul, we, as fixed income investors, required 3 percent real returns on average, why would we settle for half of that for any length of time? After all, with a globalizing world, might there be better opportunities in other markets that serve to "drag" our real yields up along the way? This is a real risk (no pun intended). So, with the Fed (jab), increasing supply (jab), and higher real yields (right cross) we think staying on the shorter maturity/duration side of the trade is the right place to be. Indeed, for our portfolios, we believe instruments that help defense against inflation and higher rates will gain added interest from investors. We have upped our allocation to floating rate instruments that also have a credit yield component, such as CLOs, in response to these concerns.

Summary

So, as we move into the second quarter, we point the Cutwater bow toward rotation away from pure systemic beta compression, and toward sector and name-specific allocation strategies, while keeping the steady course away from potentially rising rates through shorter maturities and increasing allocations to credit-based floating instruments. We wish the Fed Godspeed on a treacherous path back toward a more normal rate regime. ■

ABOUT THE AUTHOR



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