ADVISER
INVESTMENTS

Fixed Income Market Commentary

November 2012

Obama II—Changes Going Forward?

The more things stay the same, the more they (might) change.

President Obama gets another four years, while Congress remains split. If Congressional gridlock and divisiveness continues, then everything changes—and we fall over the "fiscal cliff" on January 1, 2013. Federal budget and spending reductions will take place automatically and income taxes will go up. The payroll tax will rise to 6.2% from the reduced 4.2% rate, a new health-care tax on high earners is set to go into effect and, yes, the long-standing tax cuts first implemented by the second President Bush will ride off into the sunset. Again, the more things stay the same, the more change we'll see.

The greatest concern is that, should these events all occur simultaneously, as they are supposed to, we could be facing economic Armageddon or, at a minimum, a major downshift for an already slow-growth economy. I don't expect serious discussions about avoiding (or at least rethinking) the fiscal cliff to begin until later this month at the earliest, after the election dust settles. But, I fully expect an agreement prior to year's end.

No matter how the issues are tackled, I believe that interest rates will remain low. The Federal Reserve, eschewing politics, will continue its current program of buying longer-term bonds in the open market in order to put a lid on rates and borrowing costs in an effort to stimulate the economy. With President Obama earning another four years in the White House, Chairman Bernanke's position as head of the Fed is secure.

In the meantime, the great bull market for bonds—something that began in the 1980s, continues, albeit with ever-narrowing returns. The **Treasury** market, which began the year trading at or near historically low yields, has managed to remain upright, posting a return of just under 2% through October—not bad for an asset class freighted with extraordinarily low investor expectations. Still, with an average coupon that has fallen from 3.41% in October 2009 to 2.26% today, Treasury investors who are "clipping the coupon" are getting less for their efforts.

Though it has yet to show itself, higher inflation is still on many investors' minds. **TIPS** (Treasury Inflation Protected Securities) have outperformed nominal Treasury bonds by a wide margin this year, up 7.2% through October. Inflation fears are driving performance. At October's end, inflation expectations, as measured by the difference between 10-year nominal Treasury and10-year inflation-linked TIPS yields stood at 2.49%. But inflation is currently running at 2%. Inflation hawks may be in for the same long wait as bond investors who've been predicting a sharply rising rate environment that has yet to materialize.

For all of the handwringing over the Federal Reserve's continued easing and the long period of policy-driven low, low interest rates, we have seen neither higher rates, nor runaway inflation as a result. The current slow-growth environment remains a strong defense against higher prices.

And Chairman Bernanke has all but guaranteed that short-term interest rates will remain anchored at 0% into 2015, which is about a year longer than previously suggested. In an era of great uncertainty, the Fed has been anything but. As I've said before, I expect Treasury rates to be range-bound, with the upper end for the 10-year's yield running at just 2.0% to 2.5%. At the end of October, it stood at 1.69%.

Investors who've been willing to take on credit risk have been amply rewarded by investment-grade rated **corporate** bonds. The index that tracks corporates is up almost 9.5% for the year through the end of October. Strong demand from investors is perfectly matched with eager corporate CFOs looking to borrow or refinance expensive outstanding debt. Year-to-date, more than $3.3 trillion of new corporate bonds have been sold. The record of $3.4 trillion set in 2009 looks like it will be broken.

One benefit of this low-rate environment is that corporate CFOs are happy with their low borrowing costs. Recently, Verizon, Microsoft and General Dynamics all sold bonds with coupons of 2.5% or lower on their 10-year offerings. While this is good news for the respective companies and their balance sheets, it is less good for us—the ultimate buyer and investor.

At the farther reaches of the risk continuum, non-investment-grade corporate bonds, or **high-yield bonds**, also rewarded investors who can handle the additional risk, and amply. The primary high-yield index we follow is up better than 13%, as demand and fundamentals remain aligned rather nicely.

Barclays Fixed Income Index Total Returns Through 10/31/2012						
	Duration	Oct	YTD '12	Return '11	Return '10	Return '09
US T-Bill Index	0.44	0.01%	0.11%	0.15%	0.22%	0.37%
US Treasury Index	5.52	-0.17	1.91	9.81	5.87	-3.57
US TIPS Index	5.56	0.87	7.17	13.56	6.31	11.41
US Aggregate Bond Index	5.02	0.20	2.40	7.84	6.54	5.93
US Govt / Credit Index	6.00	0.35	4.79	8.74	6.59	4.52
US Credit Index {A2}	7.11	1.12	9.46	8.35	8.47	16.04
US High Yield Index {B1}	4.11	0.88	13.11	4.98	15.12	58.21
Caa component	3.58	0.63	15.26	1.18	16.43	90.65
Emerging Market ($$) {BA1}	6.79	1.23	15.59	6.97	12.84	34.23
Municipal Index	6.83	0.28	6.36	10.70	2.38	12.91
Municipal Index - 5 Year	3.95	0.05	3.23	6.93	3.40	7.40
Municipal Index - Taxable	10.75	0.47	9.67	20.42	7.48	7.42
						Source: Barclays Capital

Defaults—always an important measure in the bond market—remain relatively mild this year. Still, they are running higher than last year's pace, as 31 companies have defaulted on bonds or loans with a face value of just under $16.5 billion this year. The default rate remains below 2%.

It is axiomatic that the lower-quality companies issuing high-yield bonds tend to perform better in a thriving economy. Even though the economy is not thriving right now (slow growth, not no-growth) these companies are still benefiting from lower borrowing costs. Those interest savings are helping out their bottom lines.

I don't see any major changes coming to the interest rate landscape, so the portfolios I manage will stay the course. I continue to pay very close attention to maturity structure and quality, and have found some small pockets of opportunity for adding incrementally to current yields when cash is available.

Christopher Keith
Senior Vice President
Fixed Income Manager