Fixed Income Market Commentary

July 2011

First Half Review: Not too far from what we expected

Key Points:

- The Treasury market continues its trend with lower rates
- The Greek tragedy revisited
- First half review

Bond prices are up; yields are down. That's not exactly what I was expecting for the first half of 2011. With the economy having moved from recovery to expansion, it was natural to assume that continued growth would drive interest rates higher and bond prices lower. And that happened for a while.

However, some disappointing reports during the second quarter roiled the bond market and both prices and yields reversed course. It was only at the end of June that, amid some encouraging signs of reinvigorated growth, the bond market turned around once again.

From 3.29% at the start of the year, the benchmark 10-year Treasury bond's yield rose to as high as 3.74% and then fell to as low as 2.86% before closing June at 3.16%. This translates into a total return of 3.21% for the first six months of the year.

It wasn't only the economic news at home that drove the bond market. World events such as the regime change protests in the Middle East and North Africa, and a flight-to-quality trade prompted by events in Greece kept Treasuries in demand. Plus, the Federal Reserve generating $600 billion worth of demand as part of its quantitative easing program, kept prices high.

But that's in the past. Now that the Fed's second effort at quantitative easing (QE2) is complete, and they've said there'll be no QE3, what should we expect?

For starters the Fed hasn't really abandoned the bond market. It will continue to re-invest the principal and interest from the Treasury bonds it holds back into the market. Those reinvestment purchases could approach $10 billion per month for the next year according to one estimate. The number could go higher. The Fed also holds mortgage bonds, purchased during QE1, which may also spin off additional funds for reinvestment.

The overall success of the quantitative easing program is debatable. On the one hand the Fed's buying did have the desired effect of further lowering interest rates. On the other hand, consumers and small businesses are still having trouble getting loans. One hoped for result of this massive injection of cash into the bond market, and economy, was to ease credit. Loan officer surveys showed banks reporting a greater willingness to lend, but actual loan numbers don't bear this out. Large corporations are still able to borrow, and many have gone to the bond markets to issue long-dated bonds at extremely low interest rates. But America's job-growth engine is in its small businesses, and so far they've been unable, on balance, to get the loans they need to expand.

Still, the economy is growing. GDP expanded 1.9% during the first quarter. While we won't get an official read on second quarter growth until late July, initial estimates are that the economy expanded another 2% or so over the past three months. If that's so, then the Fed's prediction for full-year growth of 2.8% means we can expect a much larger expansion—3.6%—in the second half of the year.

Absent a sharp move higher in growth and inflation, I see the Fed on hold for the balance of the year. For the time being though, it is against the backdrop of slower growth, high unemployment and acceptable (to the Fed) core inflation measures, that I see shorter-term interest rates remaining range-bound As always, the market will dictate what happens with longer-term rates.

As the first half drew to a close the bond market found itself refocusing on the Greek tragedy playing out in a theater right before our eyes. The problem is that the Hellenic nation cannot survive economically under current conditions and crushing debt levels. Yes, we have heard this story told before and it's time the country faced the austerity music. Greece and several other euro-zone economies are next to insolvent. Their ability to grow out of their financial predicament seems further and further from reality. Structural reform and austerity measures should have been implemented long ago.

On the home front there was a "golf summit" held at the highest levels of government to try to solve our own debt woes and raise the debt ceiling. Our nation's ability to borrow is due to hit that ceiling in early August. Two weeks later more than $150 billion in principal and interest payments come due. Three issues define the debate over this debt ceiling. The first is how much to raise it, if at all. I believe that while there may not be much to gain from raising the ceiling, there is much more to lose if we don't. A default would seem unlikely, but that is one of the options being discussed in the press. The consequences of a default would be disastrous in my opinion.

Assuming then, that the debt ceiling must be raised, politicians are battling over how and where to cut spending, and how to boost revenues by either raising taxes or cutting tax-incentives that unfairly favor one interest group over another.

I believe that what we are witnessing is primarily political posturing and a game of chicken. The mainstream media says the government will default on its debt without an increase. I disagree and fully expect that the debt ceiling will be raised. Even if it isn't, the Treasury's principal and interest payments will continue to be made on time.

While all of this is being debated in Washington, the Treasury market shows very little sense of urgency on the matter. This is politics, so look for it to come down to the wire. My guess is that a deal will be struck – just before the Congressional recess in August.

The irony is that our nation still has an economy that can support its debt, though there are many who think otherwise. The bond market agrees. The U.S. currently can borrow money for two years at less than one-half-of-one percent while Greece's sovereign debt trades at a yield of about 26%. A crisis of confidence versus a crisis of politics, I'd say.

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On a sector by sector basis, we pretty much got what we expected at the beginning of the year with the exception of the Treasury market. At quarter-end we saw some T-Bills trade back in the negative territory (I didn't see that coming) and the already mentioned flight-to-quality trade buoy the **Treasury** market overall. The Treasury index returned 2.22% for the first half of the year. The inflation-linked **TIPS** market fared much better, returning 5.81%. The investment- grade rated credit (corporate bond) market returned 3.41% as issuers found significant demand for their debt and took advantage of the lower borrowing costs that resulted. In the High Yield market returns were strong with the primary index being up 4.97%. I saw a stat the other day that suggested corporate CFOs have been busy refinancing their higher interest expense debt, as they should. For the past two years, over 60% of new high yield issues have been used to refinance this more expensive debt. This is one more reason why we see continued value in the high yield asset class.

Lastly, the predicted calamity in the **Municipal** bond market has not materialized and the index here returned a very healthy 4.42%. As we expected, a combination of budget cuts in education / healthcare / public services combined with headcount reductions and then a round of revenue increases has mitigated much of the financial imbalance and the wave of defaults never materialized. There is still more financial belt-tightening to be done as some estimates show a remaining collective $100B in shortfalls. But, the defaults have been well behind the alarmist levels that some predicted. Some will occur – as they always do, but I see them being the exceptions and not the rule for the muni market throughout the balance of 2011.

Barclays Fixed Income Index Returns Through 6/30/11

	Duration	June	YTD '11	Return '10	Return '09	Return '08
US T-Bill Index	0.33	0.01%	0.10%	0.22%	0.37%	2.44%
US Treasury Index	5.39	-0.34	2.22	5.87	-3.57	13.74
US TIPS Index	4.59	0.81	5.81	6.31	11.41	-2.35
US Aggregate Bond Index	5.19	-0.29	2.72	6.54	5.93	5.24
US Govt / Credit Index	5.58	-0.47	2.61	6.59	4.52	5.70
US Credit Index {A2}	6.43	-0.73	3.41	8.47	16.04	-3.08
US High Yield Index {B1}	4.43	-0.97	4.97	15.12	58.21	-26.16
Caa component	3.70	-1.28	5.73	16.43	90.65	-44.24
Emerging Market ($$) {BA1}	6.39	0.67	5.00	12.84	34.23	-14.75
Municipal Index	8.48	0.35	4.42	2.38	12.91	-2.47
Municipal Index - 5 Year	3.88	0.23	3.13	3.40	7.40	5.78

Source: Barclays Capital

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