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Market Review and Outlook
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Review

In April the fixed income markets as represented by the Barclays Capital Aggregate Index generated a total return of 1.27%, as Treasury yields declined in response to weaker economic data. Surging commodity prices were offset by generally better-than-expected corporate earnings. In a continuation of the trend that began in the spring of 2009, risk assets performed well, out-pacing duration-equivalent Treasuries.

The securitized sector had a good month, posting +22 bp of excess return. Stronger demand from banks and REIT's and a continued benign prepayment environment helped the residential mortgage-backed sector (MBS) outperform Treasuries by +14 bp. The Fannie Mae MBS sector lagged the Freddie Mac sector by 8 bp due to higher speeds in Fannie Mae-backed mortgages. A tightening in credit card and swap spreads enabled the asset-backed sector (ABS) to earn +16 bp over duration-neutral Treasuries. Encouraged by signs of stabilizing fundamentals and a slower pace of credit deterioration, the commercial mortgage-backed sector (CMBS), was again the best performer in the Aggregate index with +132 bp of excess return. Lower-rated tranches led the way outpacing their Aaa-rated counterparts by more than +60 bp. The credit sector posted a strong +42 bp of outperformance over Treasuries. Within credits, the financial sector was again the outperformer with +57 of excess return. In fact, long-maturity finance paper had more than twice the excess return of the overall Credit index for the month. The industrial and utility sectors earned +34 and +37 bp of outperformance respectively. The credit-quality spectrum showed increased appetite for risk with the BBB and high yield sectors posting +45 to +51 bp of excess return compared to +36 bp for the AA-rated sector. Treasury yields declined on weaker economic data with the 2-year yield declining by 22 bp, while the 30-year yield fell by only 11 bp resulting in a steeper yield curve. The 2-year/30-year yield spread differential ended the month 11 bp wider at 380 bp.

Government bonds in the developed markets underperformed the U.S. in April. The first interest rate hike by the European Central Bank (ECB) since the financial crisis widened interest rate differentials versus the U.S. In the currency markets, the U.S. dollar index (measured against a basket of six major currencies) declined sharply by almost 4%.

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Outlook

The Federal Reserve tacitly acknowledged the softness in recent economic data by stating that "the economic recovery is proceeding at a moderate pace" compared to its prior statement that the economy was on "firmer footing". Additionally, the central bank indicated that the quantitative easing program (QE2) would continue as scheduled through the end of June 2011. At the conclusion of the April Federal Open Market Committee (FOMC) meeting, Chairman Bernanke held his first post-meeting news conference to provide more transparency on monetary policy. His most notable comment was that the Federal Reserve would continue to reinvest maturing securities in its portfolio which would effectively keep the size of the Fed's balance sheet unchanged. Given the stiff headwinds that we have discussed for the past several months, this is an important signal that in the Federal Reserve's view, the economy is not yet in a position to withstand a tightening in monetary conditions. The central bank will likely remain accommodative for an extended period, which Chairman Bernanke stated could mean "a couple of FOMC meetings". As a result of the slow pace of recovery in the labor markets coupled with low core inflation (despite higher commodity prices), our view is that the Federal Reserve is unlikely to raise the federal funds rate until at least late 2011/early 2012.

Although MBS are fairly valued, originations remain light and demand is strong from banks and foreign investors. REIT buying, which has been solid since the beginning of February, could potentially become a key source of demand for the Treasury's MBS sales. Furthermore, range-bound interest rates and dwindling outstanding volume suggest a strong likelihood for most securitized product to earn incremental carry. We, therefore, have a positive allocation bias to these products in our portfolios, particularly emphasizing CMBS product, as our analysis still suggests the potential for material spread tightening in this sector. Strong fundamentals continue to underpin corporate spread valuations and we retain our overweight to this sector. We continue to favor financials as spreads remain attractive from a historical basis relative to both industrial and utility spreads. Issuer selection across all sectors, however, is becoming more critical as an increasing number of companies are shifting their focus from protecting their balance sheet and credit metrics to re-leveraging activities through M&A, share repurchases and increasing dividends.

In the non-dollar markets, the shift in debate over the European peripheral debt crisis from default to the terms of intervention will continue to drive volatility in specific sovereign names. Lastly, we remain underweight Treasuries and Agencies.