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Market Review and Outlook
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Review

In August, the broad fixed income market as measured by the Barclays Capital Aggregate Index posted a total return of 1.46%. Standard & Poor's downgrade of the U.S. long-term sovereign credit rating to AA+ with a negative outlook was a catalyst for the rout in global equity markets and the resulting flight-to-quality which drove Treasury yields sharply lower, and in the case of short-maturity Treasuries, to record lows. Consequently, all fixed income spread sectors underperformed duration-equivalent Treasuries for the month, and in most cases for the year.

The securitized sector registered -103 bp of excess return, its worst performance since November 2008. The agency mortgage-backed sector (MBS) lagged Treasuries by -90 bp as sharply higher volatility, wider spreads and convexity losses weighed on the sector. Additionally, the MBS sector was negatively impacted by renewed fears of a government-assisted program that could expand the refinanceable mortgage universe by relaxing credit and loan-to-value requirements. Although fundamentals have been improving, overall investor risk-aversion in August weighed heavily on the commercial mortgage-backed sector (CMBS) and led to -308 bp of underperformance versus Treasuries. The CMBS maturity and quality curves both steepened as higher-rated and shorter-maturity tranches outpaced subordinate and longer tranches by more than +230 bp. The asset-backed sector (ABS) held up much better with an underperformance of only -25 bp as the sector benefited from its short-maturity/ high-quality profile. In line with the dismal performance in the equity markets, the U.S. credit sector underperformed duration-neutral Treasuries by -333 bp as systemic risk fears resurfaced. The corporate curve steepened sharply as long maturity corporates underperformed intermediate issues by -428 bp. However, the quality curve steepened less due to the sizeable underperformance of the single-A rated (versus the BBB-rated) sector due to the former's heavy weighting in finance names. The finance sector underperformed by -401 bp compared to the Industrial and utility sectors which lagged by -298 bp and -279 bp respectively. Risk aversion hit the high yield sector the hardest with an underperformance of -602 bp. Treasury yields declined sharply in response to heightened investor risk aversion combined with the Federal Reserve's unprecedented announcement on August 9th that the exceptionally low levels for the federal funds rate would be maintained at least through mid-2013. The yield on the 2-year Treasury note declined to a record low 0.2%. The Treasury yield curve continued its recent flattening trend as the 30-year yield declined by 52 bp. The 2-year/30-year Treasury yield differential narrowed by 36 bp and ended the month at 340 bp.

As a result of the escalating European sovereign debt crisis, government bonds in most global developed markets underperformed the U.S. in August. Intermediate maturities in the United Kingdom, Canada and Japan lagged the U.S. by 25 to 50 bp. Australia was an exception, as weaker economic data pushed short maturity yields lower by 65 bp compared to the 16 bp decline for comparable maturities in the U.S. On the currency front, the U.S. dollar appreciated against most major currencies with the exception of the yen and the euro which were relatively unchanged versus the dollar. The decline in the British pound, Canadian dollar, Australian dollar and New Zealand kiwi ranged from -1% to almost -3%.

Outlook

The political brinksmanship and rhetoric in the negotiations to raise the U.S. debt ceiling, S&P's downgrade of the United States long-term credit rating, and the intensifying sovereign debt crisis in Europe have caused unwanted volatility in the global financial markets. Consumer and business sentiment have both been adversely affected, thereby, further exacerbating an already anemic economic recovery. The Federal Reserve has responded by committing to keep the interest rate it controls to close to zero for the next two years. In this environment, the steep Treasury yield curve is likely to continue its recent flattening trend.

MBS remain cheap. Originations have picked up as refinancing activity has increased; net supply, however, remains flat. Mortgage prices are at levels empirically associated with considerable negative convexity but prepay S-curves remain flat as a large part of the mortgage universe is credit-impaired with limited ability to refinance even with rates near historical lows. At the same time, with the Federal Reserve on extended hold, carry trades are back in vogue. We, therefore, have a positive allocation bias to these products in our portfolios. We are particularly emphasizing CMBS product, as our analysis continues to suggest the potential for material capital gains.

The sovereign debt crisis in the eurozone has created stresses in the European banking system and become a dark cloud for the finance sector in general. The corporate spread widening for U.S. banks may, however, be somewhat over-done despite the negative overhang from lawsuits related to problem mortgages. The banks have significantly repaired their balance sheets over the past 3 years and now have larger capital cushions and less leverage than even before the financial crisis. The recent $5 billion investment made by Warren Buffet in Bank of America is a positive sign for the sector. In non-financials, fundamentals remain largely intact and balance sheets are strong. We retain our overweight to the credit sector as valuations remain attractive. Issuer selection, however, is becoming more critical as an increasing number of companies are shifting their focus to more shareholder friendly activities through M&A, share repurchases and increasing dividends. The sovereign debt problems in the peripheral Eurozone regions have intensified and spread to bigger countries such as Italy. The structural nature and complexity of the issues involved present investors and policymakers with challenges. Volatility will remain in both the foreign exchange and debt markets of the eurozone until an effective long-term solution is put in place. This will weigh on the euro while providing a bid for safe-haven currencies, including the U.S. dollar, despite their unattractive interest rate differentials.

Finally, we remain underweight Treasuries and Agencies.