Market Review and Outlook

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Review

In August, the broad fixed income markets as measured by the Barclays Capital Aggregate Index posted a total return of just 0.07% as higher Treasury yields offset the outperformance from all the fixed income spread sectors.

The securitized sector had a good month with +16 bp of excess return. Supported by a carry advantage and continued negative net issuance, the residential mortgage-backed sector (MBS) outperformed Treasuries by +12 bp. Mortgages also benefited from investors' expectations of additional asset purchases by the Federal Reserve. The commercial mortgage-backed sector (CMBS) was again one of the top spread-sector performers, earning +80 bp over Treasuries. Spreads tightened despite poor seasonals and heavy bid flow activity which was mostly concentrated in later vintage and lower credit quality tranches. Despite this, lower-rated tranches outpaced their AAA counterparts by more than +24 bp. Spreads also grinded tighter in the asset-backed sector (ABS) as demand from investors and dealers helped the sector outperform duration-equivalent Treasuries by +29 bp. In the credit sector, the average spread tightened 6 bp which resulted in a +40 bp outperformance for the overall sector. Once again, the finance sector led the way with +108 bp of excess return, followed by utilities with +32 bp, while industrials managed only +6 bp. Improved investor sentiment was evident across the credit-quality spectrum as lower-rated issues outperformed: Aa +19 bp, A-rated +41 bp, Baa +50 bp and high yield +115 bp. Treasury yields rose slightly, 1 bp in 2 to 3 year maturities while in the 10 to 30 year maturities, yields climbed 8 to 12 bp. As a consequence, the 2/30-year yield differential steepened and ended the month at 241 bp.

Developed country non-dollar bond markets were little changed ahead of important central bank meetings in Europe and the U.S. Intermediate maturities in Germany and Canada underperformed the U.S. by 2 to 5 bp, while the U.K., Australia and New Zealand outperformed by 6 to 9 bp. Currency markets were mixed. Further signs of cooling in the Chinese economy weighed on the Australian and New Zealand currencies which underperformed the U.S. dollar by 0.7% to 1.8 %. Despite the ongoing turmoil in Europe, the euro gained over 2% from short-covering and jawboning by the head of the European Central Bank.

Outlook

Although the U.S. economy has lost momentum from earlier in the year, economic indicators still suggest moderate growth lies ahead. In August, nonfarm payrolls expanded a less-than-expected 96,000 and revisions to prior months subtracted 41,000 jobs. Over the past five months, monthly payroll gains have averaged 87,000, a sharp deceleration from the first quarter's average of 226,000. While the unemployment rate declined 0.2% to 8.1%, this was only because the labor force contracted by 368,000. The purchasing managers survey (ISM) for the manufacturing sector reflects the economic "softness" as the survey posted its third consecutive monthly reading below 50, which marks the dividing line between expansion and contraction. On a positive note, August auto sales were 14.5 million (on an annualized basis), 2 million higher than August 2011. Despite the European Central Bank's announcement of its plan to purchase (with conditions) an unlimited amount of peripheral sovereign debt, risks remain in the global markets that should temper investors' risk appetite. The spreading economic downturn in emerging market powerhouses such as China, India and Brazil, and the rising tension in the Middle East related to Iran's nuclear weapon ambitions are some of the major concerns. On the fiscal front, election year politics in the U.S. are causing uncertainty about how the record budget deficit will be effectively addressed, and the consequences of the impending "fiscal cliff". The Federal Reserve has acknowledged the slower trajectory of growth for the U.S. economy and reiterated its commitment to keep the key federal funds rate close to zero at least through late 2014. Additionally, a further expansion of the Fed's balance sheet cannot be ruled out if the economic outlook deteriorates further.

While originations have picked up on an increase in refinance activity, net supply is essentially flat. The Federal Reserve's sponsorship has tilted the supply/demand balance in favor of MBS. Mortgage prices remain at levels empirically associated with considerable negative convexity. Additionally, while HARP 2.0 is having a modest impact on prepayments, prepayment speeds are benign by historical standards as a large part of the mortgage universe is credit-impaired with limited ability to refinance even as rates linger at historical lows. With the Fed on extended hold, selective high-quality carry trades remain in vogue. This is especially true in agency MBS, high quality CMBS and the short-duration, liquid consumer ABS sector which still offers attractive yields as a cash surrogate. In the credit sector, although technicals remain positive, considerable macro uncertainty, spreads at/or near year-to-date tights coupled with lower earnings guidance from corporate management teams suggest a lower risk profile in this space. We will look to add spread and yield on any material spread widening, though issuer selection will continue to be critical.

Besides the sovereign debt crisis in Europe, the weakening in the global economy will also have an impact on non-dollar markets. Commodity producers such as Brazil, Australia, and Canada can be adversely affected if China experiences a hard-landing due to a structural economic slowdown. While the ECB's most recent supportive measures may provide temporary relief to the European bond markets, there are significant roadblocks to a permanent solution which would require convergence through a fiscal and political union. Consequently, volatility is likely to remain high with continued demand for safe assets.

Lastly, while we have increased our defensive posture by selectively reducing spread sector overweights, our portfolios continue to have an overall positive bias to spread sectors.