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Market Review and Outlook
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Review

In January the fixed income markets as represented by the Barclays Capital Aggregate Index posted a modest total return of .12%, as an improving economic backdrop bolstered risk assets during the month. The continuation of QE2 kept intermediate Treasury yields well bid while longer maturity yields rose 20 bp, consequently the yield curve (2-year / 30-year yield differential) steepened 26 bp to end the month at 401 bp.

The securitized sector posted a modest +11 bp of excess return during the month of January. This outperformance was attributable mainly to the strong showing by the CMBS sector, which outgained duration equivalent Treasuries by 151 bp. Secondary markets were very active and analogous to 2010, with lower rated CMBS tranches outperformed their AAA counterparts by more than 150 bp. Surging new ABS issuance was met with strong demand, enabling ABS to register 42 bp of excess return. The agency mortgage-backed securities (MBS) sector was flat to Treasuries. Fannie MBS lagged their Freddie counterparts by roughly 8 bp as Freddie announced the end of its streamline finance program, which led to Freddie pools prepaying faster over the last several months. The U.S. Credit sector outperformed duration-equivalent Treasuries by 39 bp as the option-adjusted spread for the index tightened 6 bp during the month. Financials led all other corporate sectors with 51 bp of excess return as attractive valuations, coupled with quarterly earnings that were generally better-than-expected, were the primary drivers. Utilities and industrials also beat duration-neutral Treasuries by 44 and 31 bp, respectively. Excess returns across the quality spectrum indicate a continued healthy bid for riskier assets with the quality curve flattening as follows: Aa +9 bp, A +35 bp, Baa +68 bp and High Yield +200 bp.

Government bonds in most developed markets underperformed the U.S. for the month, with the exception of Australia and New Zealand, as the resolution to the European sovereign crisis and the global recovery proceed at a gradual pace. Short-term German government bonds led the decline with rates rising over 50 bp on the month. Conversely, in the currency markets, the U.S. dollar index (measured against a basket of six major currencies) declined 1.6%. The Euro made a dramatic recovery from its low earlier in the month, as did the Sterling, as inflation fears drove them higher. The commodity levered countries of Australia and New Zealand declined verses the dollar as fear of an Asian tightening cycle centered on China weighed heavily on their currencies.

Outlook

Improving U.S. economic data coupled with the recent extension of Bush-era tax cuts, as well as a 2% reduction in employee payroll tax rates, bode well for consumer sentiment and spending in 2011. Meanwhile, the manufacturing and service sectors are surging both in the U.S. and abroad, while banks are beginning to see a pick-up in loan demand. This is a positive catalyst for job growth which is key factor to ensuring a self-sustaining economic recovery.

Despite the improved tone, there are still stiff headwinds not only in the U.S. but around the world: an unemployment rate that according to Fed Chairman Bernanke "will take several years before returning to a more normal level", a housing market that is still near recession lows, budget deficits at both the federal, state and local levels, rising oil prices, a European debt crisis which is structural in nature, social unrest in the Middle East/Africa and emerging markets like China and India trying to engineer a soft-landing. As a result, monetary conditions will remain very accommodative and the Federal Reserve has reiterated its commitment to employ all policy tools necessary to achieve its dual mandate of maximum employment and price stability. The slow pace of recovery in the labor markets, coupled with low core inflation, make it unlikely that the Federal Reserve will raise the federal funds rate until at least late 2011/early 2012.

Fed on hold, range bound rates and generally dwindling outstanding volume suggests strong odds for most securitized product to earn incremental carry. While we have a positive allocation bias in general to securitized product, we particularly emphasize the CMBS sector, as our calculations still suggest potential for material capital gains. We maintain our overweight to the corporate market as fundamentals (profitability and balance sheets) are strong and should remain supportive of spreads. We continue to favor financials for better excess return potential as improving asset quality and strong capitalization ratios, coupled with still compelling valuations relative to industrial and utility spreads. Nonetheless, issuer selection is critical as some companies are shifting their focus to shareholder rewards at the expense of bondholders. In the non-dollar markets, while the emerging resolution mechanism should produce increased confidence in the region and result in improved sentiment, underlying risk of European peripheral sovereign crisis remains. The momentum of the economic recovery continues to increase in the developed economies and the efforts of policy makers to slow growth in emerging economies, specifically China and India will likely result in only a more temperate pace. Although commodity-levered economies carry heightened volatility in this environment, they continue to offer attractive opportunities. Despite the backup in interest rates over the past few months, we still remain underweight Treasuries and Agencies.