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Market Review and Outlook
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Review

In January, the broad fixed income market represented by the Barclays Capital Aggregate Index posted a total return of 0.88%. Improved market sentiment coupled with better-than-expected economic data resulted in strong performance for risk assets. All major fixed income spread sectors outperformed duration-equivalent Treasuries.

The securitized sector posted +22 bp of excess return. This was primarily driven by the commercial mortgage-backed sector (CMBS), which outpaced Treasuries by +164 bp. Activity and liquidity were noticeably improved in the CMBS secondary markets. Lower-rated tranches outperformed their AAA-rated counterparts by more than +80 bp. The asset-backed sector (ABS) had a firm tone as several new issues were multiple times oversubscribed. Tighter swap spreads contributed to the +84 bp of outperformance for the sector. The agency mortgage-backed (MBS) sector was a modest +12 bp ahead of Treasuries as favorable technicals and lower volatility helped the mortgage basis. Higher coupons, in general, were under pressure from the anticipated effects of the Home Affordable Refinance Program (HARP 2.0) as well as the prospects for further policy initiatives to help more homeowners refinance. The uncertainty of new policy initiatives weighed especially on GNMA-backed mortgages which lagged conventionals by nearly 20 bp. The U.S. credit sector continued its spread tightening trend from late in the 4th quarter of 2011, posting +165 bp of excess return. The credit sector's performance was led by banks which outpaced Treasuries by +362 bp. This was the highest monthly excess return for the sector since July 2007 and the fourth highest on record. The Industrials and utilities sectors also had positive excess returns of +114 and +75 bp, respectively. Credit quality performance mirrored the improved risk-appetite environment with the AA-rated sector posting +108 bp, BBB's +164 bp and high yield +256 bp for the month. Despite the strong performance for risk assets, Treasury yields remained near record lows. In fact, the 5-year Treasury's yield closed the month at a record low 0.70%, while the 10-year Treasury yield ended at 1.8%. The yield curve (as measured by the 2-year/30-year Treasury yield differential) steepened by 7 bp to 272 bp.

The sovereign debt crisis in Europe remained a driving factor for the non-dollar markets. Constructive steps toward a possible resolution of the crisis resulted in a 10 to 18 bp widening of interest rate differentials versus the U.S. For the month, the U.S. dollar index declined 1.3%. The New Zealand dollar led with a 6.3% rally. In spite of the troubles in the European Union, the euro finished the month up versus the dollar by almost 1%, while the British pound rose 1.4%.

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Outlook

Economic data releases for the U.S. are increasingly pointing to signs of a self-sustaining economic recovery. The January employment report showed that payrolls increased by 243,000, much larger-than-anticipated, while the unemployment rate fell 0.2% to 8.3%. In January, vehicle sales rose to a 14.2 million annual rate, well above consensus, and the highest since May 2008, excluding the cash-for-clunkers program. Furthermore, U.S. manufacturing and service sector surveys continue to indicate economic expansion. Interestingly, even some of the economic data points coming out of Europe indicate improvement as well. However, there are risks to the global markets. The on-going European sovereign debt crisis, as well as the rising risk for a preemptive Israeli strike on nuclear facilities in Iran are sources of concern. On the fiscal front, election year politics in the U.S. are causing uncertainty about how the record budget deficit will be effectively addressed. Although the likelihood of a recession in the U.S. has diminished significantly, the Federal Reserve has reiterated its commitment to keep the interest rate it controls close to zero until late 2014 due to the risk of contagion from Europe, continued weakness in the housing market and a still elevated unemployment rate. Furthermore, the Federal Reserve has not ruled out further expansion of its balance sheet through asset purchases if the economic outlook worsens.

While mortgage originations have picked up on an increase in refinancing activity, net supply is flat. Adding to demand from money managers, REITS and banks, the Federal Reserve's additional 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 could have a modest impact on prepayments, 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 and the recent FOMC statement affirming low rates until late 2014, carry trades remain in vogue. We have a positive allocation bias to securitized products in our portfolios, particularly emphasizing CMBS, as our analysis suggests the potential for material capital gains. Also, the high quality and liquidity that short-duration consumer ABS provide as cash surrogates make them attractive. We retain our overweight to the corporate sector as valuations remain compelling. Despite the two month rally in the bank and finance complex, spreads remain attractive relative to the more defensive industrial and utility sectors. Although earnings estimates are being lowered for non-financials, credit fundamentals are intact and spreads offer incremental carry over Treasuries. Issuer selection, as always, remains critical. The prospect for a more comprehensive solution to the European debt crisis, and the positive actions of the ECB have combined to create a general improvement in the funding environment for the European financial markets. This will reduce the safe-haven appeal for German and U.S. government securities.

Finally, we remain underweight Treasuries and Agencies.