Review

In July, the broad fixed income markets as measured by the Barclays Capital Aggregate Index generated a total return of 1.38% as yields fell and risk assets outperformed despite global economic weakness and the continued Eurozone debt-crisis. All major spread sectors in the fixed income markets posted positive excess returns for the month.

The securitized sector had a good month, posting +33 bp of excess return. The agency mortgage-backed securities sector (MBS) modestly outperformed Treasuries by +28 bp despite primary rates remaining near all-time lows and the refinance index approaching the highs of the year. MBS benefitted due to carry and spread tightening as market participants anticipate that the Fed will continue to remain a buyer of MBS as the housing sector remains soft. The commercial mortgage-backed sector (CMBS) was one of the top performers in the Index, earning +119 bp over Treasuries. In the asset-backed sector (ABS), spreads held firm as several new issue deals were all several times oversubscribed. Overall, the sector posted +26 bp of excess return as swap spreads tightened by nearly 5 bp. The average spread in the credit Index tightened by 18 bp, resulting in +148 bp of outperformance versus duration-neutral Treasuries. The finance sector led the way with +171 bp of excess return as better-than-expected second quarter earnings (versus lowered expectations), and attractive valuations bolstered the sector. The industrial and utility sectors also posted a strong month with +159 and +147 bp of outperformance respectively. Despite improved investor sentiment, the high yield sector with an excess return of +125 bp could not keep pace with the investment grade sector; credit-quality excess returns were: Aa +73 bp, A-rated +162 bp, Baa +174 bp. Treasury yields continued to fall, making new record lows as economic weakness and the Federal Reserve's extension of "Operation Twist" resulted in further yield curve flattening. The 2-year yield declined by 9 bp while the 30-year dropped by 21 bp, narrowing the yield curve differential by 12 bp to end the month at 233 bp.

The non-dollar developed markets had mixed performance for the month. The European Central Bank (ECB) cut the official interest rate early in July in response to the continuing debt crisis and economic slowdown in Europe. The flight to safety in the Eurozone bolstered the German bond market which outperformed the U.S. by 15 bp in intermediate maturities. The U.K. bond market also outperformed the U.S. by a similar magnitude on indications by the Bank of England that the weak economic recovery in the U.K. left the door open for further monetary easing. On the other hand, better growth prospects in the natural resource exporting countries such as Australia, New Zealand and Canada resulted in those bond markets underperforming the U.S. by by 12 to 30 bp. The currency markets reflected the factors influencing the bond markets. As a result, while the euro lost almost 3% against the U.S. dollar, the Canadian, Australian and New Zealand dollars rallied by 0.9% to 2.6% versus the U.S. The Japanese yen also gained just over 2%.

Outlook

Although the U.S. economy has lost momentum from earlier in the year, economic indicators still suggest moderate growth lies ahead. In July, nonfarm payrolls increased a better-than-expected 163,000 (consensus 100,000), but the unemployment rate ticked higher to 8.3%. Auto sales and manufacturing data confirm the economic "softness" in July as auto sales were 14.1 million (on an annualized basis) from the 14.3 million rate in June, while the ISM manufacturing index was little changed. On a positive note, the services sector survey showed some improvement and was above consensus expectations. Apprehension about the increasing risks in the global markets has led to greater demand for "safe assets". Investors' concerns include the on-going European sovereign debt crisis with a focus now on Spain and Italy, slowing growth in emerging market powerhouses such as China, India and Brazil, and the tension in the Middle East related to Iran's nuclear weapon ambitions. 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 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 and volatility warrant lower risk exposure heading into the seasonally weak period for credits. We will look to add spread and yield on any material spread widening, though issuer selection will continue to be critical.

The optimism following the recent summit meeting of Eurozone leaders has faded, thus, underscoring the fact that there is no quick fix to the problems in Europe. The balancing act between austerity measures to bring fiscal budgets under control and growth programs to alleviate the painful recession in many parts of the region remains a major challenge. Consequently, the investment landscape will be colored by higher volatility and bouts of flight-to-quality which will continue to underpin safe-haven currencies such as the U.S. dollar and the Japanese yen.

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.

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