Market Review and Outlook

May 2012

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Review

In May, the broad fixed income market as represented by the Barclays Capital Aggregate Index generated a total return of 0.9%. All major fixed income spread sectors underperformed duration-equivalent Treasuries as global risk aversion ratcheted up.

The securitized sector posted -65 bp of excess return, its worst performance in 9 months. As the yield on the 10-year Treasury moved decisively below 2%, wider swap spreads and convexity losses resulted in the agency mortgage-backed securities sector (MBS) underperforming Treasuries by -64 bp. The commercial mortgage-backed sector (CMBS) also lagged, posting -73 bp of excess return. Higher-rated and shorter maturity tranches modestly outperformed their subordinate and longer counterparts by more than +30 bp. Despite strong investor interest, the asset-backed (ABS) sector could not overcome the widening in swap spreads and ended up trailing duration-neutral Treasuries by -19 bp. The U.S. Credit Index widened 23 bp during the month as renewed anxiety over the European debt crisis along with weaker-than-expected economic data took center stage. Sector underperformance was fairly evenly distributed: industrials -161 bp, utilities -141 bp and financials -163 bp. The one notable laggard was the long-maturity financial sector which trailed duration-equivalent Treasuries by -432 bp. Credit-quality performance reflected investor risk aversion: Aa-rated -88 bp, A-rated -153 bp, Baa-rated -214 bp and high yield -226 bp. In this environment, long maturity (30-year) Treasury yields plummeted by 47 bp, while intermediate yields reached a new historical low of 1.56% for the 10-year Treasury. As a result, the 2-year/30-year Treasury yield differential narrowed by 47 bp to 238 bp.

Most developed-country bond markets outperformed the U.S. for the month of May on renewed fears about sharp economic slowdowns in economies outside the U.S. Five-year government yields in Germany, Canada and the U.K. declined by 11 to 29 bp more than comparable maturity U.S. yields.

An unexpectedly large 50 bp cut in official interest rates by the Reserve Bank of Australia (RBA) caused 5-year yield differentials in New Zealand and Australia to narrow by 38 to 68 bp respectively, versus the U.S. Reflecting the weakness in foreign economies, the U.S. dollar index rallied strongly by +5.4%. Notable losers on the currency front (versus the U.S. dollar) include the New Zealand dollar (-7.9%), Australian dollar (-6.7%), euro (-6.6%) and even the Canadian dollar (-4.4%). Only the Japanese yen gained versus the dollar (+1.9%) on the heels of the flight-to-quality.

Outlook

Macro-economic data continue to point towards a lower trajectory for growth not only in the U.S. but globally. In May, U.S. employers added the fewest number of jobs in a year as payrolls rose 69,000, bringing down sharply the 3-month average to 96,000 versus the prior 3-month average of 252,000. The unemployment rate ticked higher to 8.2%. U.S vehicle sales also showed some softness as sales declined to 13.8 million (on an annualized basis) from 14.4 million, which is likely to lower real consumption growth for the second quarter. Additionally, manufacturing surveys, both in the U.S. and abroad, have decelerated indicating a slowing global economy. On a positive note, the U.S. non-manufacturing (services) survey rose marginally in May.

Demand for "safe assets" has risen on increasing risks to the global markets. These risks include the on-going European sovereign debt crisis, the tension in the Middle East related to Iran's nuclear weapons ambitions, and slowing growth in emerging economy powerhouses such as China, India and Brazil. 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 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 originations have picked up on an increase in refinance activity, net supply is flat. 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 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 and the recent FOMC statement re-affirming low rates until at least late 2014, selective high credit-quality trades remain in vogue. This is especially true in the more credit-sensitive CMBS sector. Short-duration, liquid consumer ABS should continue to provide stability and serve as cash surrogates. In credit, fundamentals and market technicals remain positive but given the considerable macro uncertainty, reduced risk exposures are warranted.

There is no quick fix to the problems in the Eurozone. The piecemeal approach that has been employed thus far has not served as the foundation for a long-lasting solution to the sovereign debt crisis. The fragmented nature of the responses by politicians and policy makers has increased the odds for a further escalation of the crisis. Consequently, the investment landscape will be colored by higher volatility and bouts of flight-to-quality which will continue to underpin the U.S. dollar.

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