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Market Review and Outlook November 2011

Review

In November, the broad fixed income market as measured by the Barclays Capital Aggregate Index generated a total return of -0.1%. Concerns about the widening debt crisis in the eurozone offset improved U.S. economic data. Consequently, most fixed income spread sectors underperformed duration-equivalent Treasuries.

The securitized sector posted -20 bp of excess return. This was mostly attributable to the agency mortgage-backed sector (MBS) which lagged Treasuries by -22 bp. Wider spreads and higher volatility were key contributing factors for this weakness. Higher coupon MBS exhibited better resiliency, despite lower Treasury yields, and marginally outperformed their lower coupon counterparts. The commercial mortgage-backed sector (CMBS) surprisingly shrugged off stock market volatility and outperformed Treasuries by +8 bp. Despite good demand for new issuance, the asset-backed sector (ABS) modestly lagged duration-equivalent Treasuries by -7 bp as swap spreads widened by 5 to 9 bp. The U.S. credit sector underperformed duration-neutral Treasuries by -257 bp, as the overall sector's spread widened by 38 bp. November was the second worst monthly performance for the credit index since October 2008. Fears of contagion from Europe's crisis resulted in the finance sector posting -367 bp of excess return, while industrials and utilities trailed Treasuries by -265 bp and -156 bp respectively. Credit quality performance was mixed as the AA-rated sector lagged by -178 bp, compared to -275 bp for the BBB-rated sector and -259 bp for the high yield sector. Despite the risk-aversion, Treasury yields were little changed for the month with the 2-year yield rising 2 bp to 0.25%, while the yield on the 30-year bond declined by 8 bp to 3.05%. The 2-year/30-year Treasury yield differential narrowed to 280 bp.

Most of the developed non-dollar markets outperformed the U.S. in November on the heels of stronger U.S. economic data and the weakness on Europe. Consequently, the U.S. dollar index strengthened +2.9% as the euro declined by -3%, while the New Zealand dollar weakened by -3.3%. Only the Japanese yen with its safe-haven status strengthened by +0.7%.

Outlook

The widening European sovereign debt crisis is now firmly on center stage heightening investor nervousness and market volatility. Consequently, the likelihood of a recession in Europe has now appreciably increased. On the other hand, for the past nine weeks, U.S. economic data releases have been better than expected. The monthly employment reports show that job gains have been averaging 132,000 this year. Household employment has been even stronger, averaging +318,000 per month over the past three months, while the unemployment rate has dropped sharply to 8.6%. Vehicle sales rose to a 13.6 million annual rate in November, the highest level since the “cash-for-clunkers” program in August 2009. Manufacturing and service sector surveys also indicate expansion. While the odds of a recession in the U.S. have gone down significantly, the Federal Reserve has reiterated its commitment to keep the interest rate it controls close to zero for the next two years 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 a further expansion of its balance through asset purchases if the economic outlook worsens.

Our relative-value framework indicates agency MBS are cheap. 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, adding to demand from money managers, REITS and banks. Mortgage prices remain at levels empirically associated with considerable negative convexity. Additionally, while HARP 2.0 could have a modest impact on prepayments, prepayment speeds are benign by historical standards as a large part of the mortgage universe is credit-impaired with a limited ability to refinance even as rates linger at historical lows. With the Fed on extended hold, carry trades remain in vogue. We, generally, have a positive allocation bias to securitized products in our portfolios, particularly emphasizing CMBS, as our analysis suggests the potential for material capital gains. The sovereign debt crisis in the eurozone has created stresses not only in the European banking system but also in the U.S. money center banks via sovereign exposures. The spread widening in financials may, however, be somewhat over-done as net exposure to sovereign credit is manageable when measured against tangible common equity for the big U.S. money center banks. These banks have significantly repaired their balance sheets over the past 3 years and now have larger capital cushions and less leverage than before the financial crisis. Additionally, technicals for this sector are favorable as net issuance for this group remains negative. In non-financials, fundamentals remain largely intact and balance sheets strong. Issuer selection, however, remains critical. The non-dollar markets will continue to remain under siege due to the unfolding sovereign debt crisis, and the specter of a looming recession in Europe.

Finally we remain underweight Treasuries and Agencies.