Macquarie Allegiance

Fixed Income Commentary | October 2009

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October was another good month for spread product. However, as the year of credit continues, bigger questions are coming to the fore. Those questions are turning to the outlook for 2010.

We evaluate the current risk trade environment

Fundamentals, valuation and technicals. These three factors sum up our approach to asset class analysis. It is within this context that we assess the outlook for the 'risk' trade, namely in the credit markets, which just passed through its seventh consecutive month of excess returns.

Our models are signaling a bullish view on credit, but value is only one part

Spreads on Investment Grade (IG) credit have rallied from a record 545 basis points in mid-December to a spread of 187 basis points at the end of October (source: Barclays). Despite the enormity of this rally, IG spreads are still more than one standard deviation wider than the historical average (we use 20 years of data to calculate this average). Our valuation models are still signaling that IG credit is cheap, however we see "value" as only one part of the overall investment strategy. Fundamentals are crucial. We will take a detailed look into some of the key indicators.

3rd Quarter earnings beat expectations, but equities fell for the month on uncertain future guidance

Earnings. There is no doubt the expectations bar for earnings had been raised for Q3. With roughly over 400 of the S&P 500 companies having reported at the time of writing, the result has been much better than expected, both in terms of EPS (through October 84% of companies have beaten consensus expectation) and in terms of sales (through October, 58% of companies have beaten consensus expectations). Despite this, the S&P 500 fell almost 2% in October (although it did post a new cycle high during the month). In addition, equity volatility, as measured by the VIX index, spiked back above 30 at the end of the month, after touching 20 earlier in the month. Many factors can be cited to explain the weak price performance relative to earnings results, however in our view it is a general lack of clarity on the future that is driving the weakness.

Business sentiment improving amidst weak consumer data

The Economy. The October ISM report showed another strong gain, shooting to 55.7. Several economists are focusing on the prospect of inventory adjustment fueling stronger GDP figures in the coming quarters. While the potential is clearly there for an "inventory led" kick to growth, the fact that consumer confidence remains weak is a concern to asset markets. This concern was again revealed when the employment report was released, showing the unemployment rate shooting to 10.2%. This dichotomy within the economic data is starting to weigh on market sentiment as we head towards the end of 2009 and focus turns to 2010. Fiscal policy is playing an important role in underpinning the economic recovery, although there are concerns that the consumer (and the recovery) is becoming dependent on schemes such as cash-for-clunkers; and, home buyers tax credit. The Q3 GDP report revealed that the consumer savings rate actually fell in the quarter, somewhat worrying when the consumer needs to be de-leveraging and increasing savings.

Technical's have broken the trendlines, a cautious sign

Technicals. As October drew to a close, the S&P 500 was breaking through trendline support that had defined the rally from the March 6th low. This price action was being mirrored in other asset classes: namely, the dollar; EM equities (EEM US on Bloomberg); and High Yield ETF (HYG US on Bloomberg).

Changing technical patterns make traders nervous. As we start November the price action has recovered and the threat to the trending patterns of the past seven months remains intact. That said, investors are 'on' these trends and from a market positioning perspective we need to alert to the fact that if these chart patterns do change in the months ahead that there will be a crowded charge for the exit.

Favorable environment for spread product remains

Our investment process works on a scorecard system and the net result of the above signals is that our credit scores remain positive, but slightly less so. From an investment perspective, this translates into staying long risk assets but be watchful.

Treasury valuations are rich and will remain so until a change from the Fed

In last months newsletter we pointed out that at current yield levels the government bond markets were the next 'accident waiting to happen'. This view was simply based on the still extreme valuation, particularly at the short end of Sovereign yield curves. Despite this statement, the U.S. bond market continues to be range bound. We are not surprised. The Fed continues to signal the recovery does not look sustainable and the Fed Funds rate will be kept low for an extended period. Thus, with the Fed holding official rates near zero, the carry for holding Treasuries out on the curve is still extremely attractive. So, the straw that will break the back of the bond market is most likely to be the signal change by the Fed, implying the arrival of sustainable recovery and that the Funds rate can be normalized

Identifying the triggers into 2010 will revolve around Fed action

In summary, we are in an environment where valuation for sovereign bonds is expensive and credit remains cheap; where the macro fundamentals are continuing to improve; but the recovery is not yet broad based. In this environment one has to identify triggers for changing the investment strategy. The key fundamental debate is whether 2010 will deliver an extension of the V shaped recovery or will growth prove stagnant and resemble a U or W. Here we believe the role and view of the Fed will be pivotal.

We would expect a six month lag from a change in language to a change in policy

If the Fed believes the US economy is on a sustainable growth path it will begin to remove monetary accommodation, which is at extreme levels. If the economic data holds up as many economists are forecasting then each FOMC meeting will be scrutinized intensely for any change. To this affect we delved back into the period 2003-2004 when the Fed was holding monetary policy at a relative extreme. We can observe that the Fed signaled a change in its language at the December 9th FOMC, which continued to evolve until a rate hike was delivered in June 2004. ***We expect financial markets to use history as a guide when interpreting the eventual change policy shift by the Fed, with roughly a six month window being opened to the eventual change in policy being delivered.***

When we look back at the December 2003-to-June 2004 period in terms of price action in asset markets we can observe the following: (i) the US yield curve shifted sharply higher and flattened by around 50bp; (ii) IG and HY credit spreads were largely unchanged to slightly tighter; (iii) EM spreads where roughly 50bp wider, clearly underperforming IG and HY; (iv) the S&P actually rallied 80 points (from 1060 to 1140); (v) volatility, measured by VIX fell by 3 points; (vi) the USD was flat. (source: Bloomberg)

Expectation continues of an on hold Fed well into 2010

In 2003-2004 the Greenspan Fed waited until it was clear the economy was on a sustainable recovery path. How the Bernanke Fed chooses to navigate will prove crucial. At present, we do not have a sustainable recovery as the consumer is not on board. This suggests there is still some time before we should fear the Fed, however, given the unprecedented level of fiscal and monetary stimulus that has been unleashed, it is possible that the Fed could move sooner than the currently expected and investors must stay vigilant.

Stay long credit, neutral duration but watch for a change in tact

We therefore will be watching signals from the Fed very closely going forward. In the interim, the key economic data, particularly from the consumer will be our focus. So our view is stay long credit, neutral on duration, but continue to watch this space in 2010 for an eventual change in tact.

Portfolio Positioning and Strategy

Macquarie Allegiance manages separate accounts, invested in a variety of fixed income securities, including Government-only, AAA-only and Investment Grade portfolios. Below is a summary of our Investment Committee views at month end.

Duration: *At benchmark*. Our range trading view remains in tact, supported by the Fed signalling it's on hold for an extended period and expectations for inflation still benign.

Lower trend inflation and valuations continue to advocate curve flattening

Yield Curve: *Flattening.* Despite the recent steepening of the yield curve, we continue to view the front-end of the yield curve as overvalued. This overvaluation (namely in 2 Year Treasuries) leads us to overweight intermediate securities for coupon advantages. We continue to significantly underweight short maturity Treasury's in favour of high coupon Agency MBS.

Range bound environment to continue for Treasuries

Treasury and Agency: *Underweight Treasuries, neutral/underweight Agencies*. We continue to underweight Treasuries and Agencies in favour of higher yielding asset classes. Treasuries look to remain range bound as economic activity improves but inflationary measures are trending lower. Unless we see a break of key technical levels (currently 4% for the 10-year) we will tactically increase and decrease our exposure through the range, seeking to capture capital gains.

Barclays Agency MBS Index up 6.04% through October

Agency MBS: *Overweight*. We have advocated an overweight in Agency MBS throughout the year and the sector continues to perform well. The focus of our position is up-in-coupon (6 % - 6.5%) securities, which from our perspective have limited prepayment characteristics and an attractive return profile. Agency MBS have been a primary driver of returns in our AAA-only portfolios.

The year of credit continues

Corporate Bonds: *Overweight.* The "year of credit" continues as Corporate bonds are on path for the largest outperformance (excess returns) to Treasuries in the history of the Barclays Indices. Through October the Barclays Corporate Index is up 17.93%. We have continued to gradually increase our exposure throughout the year, although the speed of spread compression has occurred quicker then we expected. Credit markets remain in the "sweet spot" while macro policy continues to focus on high stimulus. That said, the period of rapid spread compression is nearing an end and our focus remains firmly of bottom up name selection for outperformance.

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