Macquarie Allegiance

3rd Quarter Review and Outlook

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I have always enjoyed reading history, but living it is a bit more stressful.

Risk assets higher on all fronts and firing on all cylinders

Twelve months ago financial markets were looking over the precipice and staring into a blackhole. Today financial markets are rallying on all cylinders. Credit markets, and to a lesser extent equity markets, had a great starting point for this rally as prices had fallen to incredibly stressed levels. Perhaps the big surprise of the past six weeks was the rally in government debt markets, where traditional theories would predict much higher interest rates given the rally in risk assets. However, these are not normal times.

Our models continue to indicate further spread compression ahead for the credit related sectors

We can use history as a guide to our analysis, using the yield curve as an example. Our historic models suggest that once an inverted U.S. yield curve turns positive, credit spreads should widen over the coming 16-22 months. The spread widening of this cycle lasted 19 months, peaking in December 2008. Based on our analysis of the relationship between the yield curve and credit spreads, we estimate that once the yield curve has peaked, May 2009, the following 13 months should result in a positive environment for credit markets. This encouraged us to move our investment grade strategies from under to overweight credit during the first two quarters of 2009. (see details of the above analysis, available through our website, in 'Investment Perspective #2, The Yield Curve and Credit Spreads').

Portfolio positioning was additive to our performance, namely in spread product

Our overweight in credit for our investment grade strategies and spread product in general, in particular Agency MBS for our Government portfolios, made positive contributions to performance, during the 3rd quarter. This rally in risk and spread sectors was supported by two major factors: (i) enormous liquidity and stimulus from governments and central banks; and then by (ii) economic data continuing to beat expectations.

The Fed is on hold well into 2010 as employment remains a headwind, and thus the consumer

On the macro front, the good news has been captured by the ISM data, with the manufacturing index rebounding from 32.9 in December 2008 to 52.6 in September 2009. The free falling housing market appears to have stabilized/bottomed according to recent data. However, the residual concern is the consumer, where retail sales remain sluggish and the rebound in consumer confidence has been tepid when compared to previous cycles. Here the labor market is playing a key role for market strategists, as the unemployment rate continues to rise, and history dictating that the Fed normally does not move to raise interest rates until roughly 6 months after unemployment has peaked.

Australia first to begin normalizing rates

The panic conditions of one year ago resulted in the adoption of unorthodox policies. The rally in risk assets has markets talking about the eventual need to withdraw this extraordinary stimulus. Indeed, in Australia we recently witnessed the first G20 country to hike rates post the crisis. Bond markets in the U.S. have shrugged off any fear of a near term Fed rate hike, justifiably as the September 23rd FOMC meeting stated '*The Committee will maintain the target range for the federal funds rate at 0 to ¼ percent and continues to anticipate that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period*'.

Reflationary policies and low inflation led us to view risk assets in a 'sweet spot'

This has led us to conclude risk assets are in an investment 'sweet spot', supported by both evidence of economic recovery and by accommodative policy. We therefore continue to hold an overweight credit position in our investment grade strategies, but maintain a disciplined bottom up name selection and an emphasis on liquidity so that we can navigate through the inevitable corrections we believe will come in the months ahead.

Government bond markets continue to perform well, surprising some

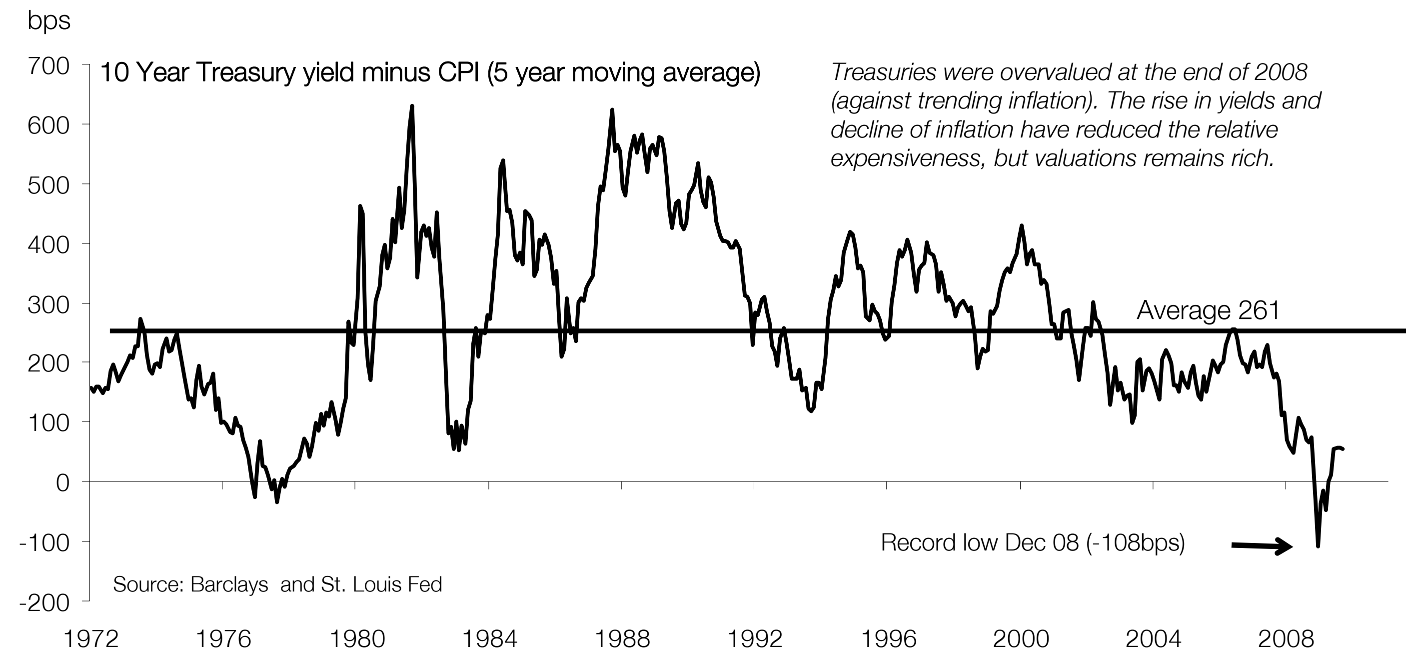
A bigger dilemma for the market in the short term is understanding the performance of the government bond market against a background of rallying risk assets. Historically, government bond yields tend to move higher once economic recovery gets underway. Indeed, economists have concluded that the US recession ended in the 2nd quarter, with 2nd half 2009 growth expected to average just under 3% annualized (above the Fed's estimate of long run trend growth). 10 year Treasury yields rose, from near 2% in December 2008 to almost 4% in mid-June 2009. However, since early August, 10 year yields have moved down to around 3.25%. This move has been highly correlated with a strong rally in both equity and credit markets.

Low inflationary expectations will give the Fed latitude in pursuing policy

Positive returns in both equities and treasuries are rare but there is historical support for such circumstances. ***The key ingredient supporting the dual rally in our view is low inflation, and more importantly the expectation that inflation will remain low despite stronger economic growth.*** This situation is giving the Fed the latitude to persist with its massive monetary stimulus to ensure a sustainable economic recovery.

Easy monetary policy to continue until strong uptrend in growth

Bond yields have not only fallen, but the yield curve has flattened (that is, long-dated yields have fallen more than short-dated yields). A bull flattening yield curve is statistically a rare event, so again we are not in normal times. We can again turn to history and observe that as Japan struggled with deflation in the 1990's the JGB curve bull flattened for a sustained period of time. However, the bull flattening was largely a result of policy mistakes made by the government and central bank in dealing with their own version of a financial crisis. Chairman Bernanke, a student of economic history, seems keen to avoid the mistakes of Japan. So, it seems a fair assumption that the Fed will maintain easy monetary policy until it gets a clear signal that the recovery is sustainable.



The consumer remains absent from the recovery, sparking debate over sustainability

The issue going forward is therefore what could tip the balance for the Fed? To date, the U.S. recovery has not been balanced. Yes, manufacturing has recovered, but consumer spending remains sluggish and employment has barely recovered. This, combined with declining average earnings has many analysts skeptical on the sustainability of economic recovery through 2010 (that is, the 'V' versus the 'W' debate).

Our work is focusing on the shape of the recovery

Our focus is therefore on the shape of the economic recovery. For example, trending weekly initial unemployment claims has improved to 550K during Q3 from levels around 650K at end Q1, but momentum for improvement has stalled. If this data more closely resembled a typical recovery and continues to trend downward then it would soon trend below 500K and head toward 400K. This would have positive implications for consumer confidence, consumer spending and therefore the sustainability of the recovery.

We are in a conducive environment for risk assets

In conclusion, we believe that we continue to be in the sweet spot for risk assets, implying an overweight position in credit markets and a need for beta exposure. In our view, It appears this environment will be sustained, at least into early 2010 as spreads return toward historic averages. Government bonds may also perform in this environment, sustained by a diet of low interest rates, low inflation and concern over the sustainability of the recovery in 2010.

The eventual adjustment in rates will be dependant upon the shape of the recovery

However, we are under no illusion that while credit was the accident waiting to happen in 2006-2007, government bond markets may face an eventual adjustment up in rates, and a potentially quick and sudden one…… we just don't know when. Our focus needs to be on the shape of recovery for signals. With the G-7 countries now funding enormous deficits, the longer this easy monetary policy is sustained, the risk is creating the next accident. History has shown that the more a market becomes overvalued the greater will be the eventual adjustment.

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