



When the going gets tough, the tough get going

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The risk euphoria of 2009 has faded quickly in the new year. The S&P punched ahead by 3.3% in the first two weeks of January only to slump by 7% into month end, resulting in a -3.6% month-on-month change (source: S&P). Credit markets traded in lock step with equities. Treasuries, particularly the belly of the curve, outperformed, with 5-year yields dropping almost 36bp (roughly a 50% reversal of December's rise in yields, source: Barclays). The important take-away from January was the realization across financial markets that sovereign risk is a long term problem.

Greece is being asked to respond as investors position for uncertainty

I realize by now you will have already read several research articles on sovereign risk and know more about Greece than you did just one month ago. However, I have actually lived through a few of these fiscal disturbances and the common point is that each is rarely that different from the last. This point is important. Once fiscal policy gets out of control, and Greece racking up its deficit/GDP ratio to 16% is clearly out of control, the focus is on confidence. Typically, the deficit position rises to a tipping point, where financial markets say enough and investors begin to sell (or buy protection with CDS). Here the sovereign is asked to respond. Now investors know it will take time to get said deficit under control, so what they are looking for is a credible and sustainable plan. If this is not achieved the mood of investors may shift to another level and the selling may intensify.

A plan for Greece will need to provide credibility for its issuance

So, Greece is now operating at the new higher level of investor focus, that is, we don't believe the plan. Markets are now looking for either of two scenarios: (i) commitment by the Greek people to sustainable fiscal consolidation – I remember when Prime Minister Paul Keating rallied the population in Australia in 1986 by declaring the country a 'banana republic'; or, (ii) a bailout of the fiscal problem by the EU and/or the IMF. If this is not forthcoming then investors may take selling Greece to the next level. While Europeans own most of the Greek debt, traders can now short Greek debt using CDS and after the debacle of January (from an investors point of view) each new attempt to tap the market may become a major event risk for the sovereign market.

Its is not so much an issue of Greece, it's the larger issue of contagion, akin to 2008 and financial institutions

In reality, Greece is just a sideshow. The real threat is contagion. Remember all the way back to 2008. ...when financial markets realized that banks were the troubled asset class and one by one they starting to pick on the weakest and worked their way up. ...and it was only when a kitchen sink bailout was delivered that the selling stopped. Well in the sovereign space things appear to be no different. Portugal and Spain have fiscal problems to deal with and markets are now looking at them too. Italy is also being dragged into the fray (which works nicely to form the acronym 'PIGS') but the real focus of strategists are the UK and the US – as any meaningful escalation in fiscal concern in either of these heavyweights would take the sovereign risk to a much higher and more dangerous level. For the record, I do not believe that the EU will allow Greece to default. However, the path toward a sustainable resolution may be long, difficult and continually testing.



Accommodative policy remains as the rebound in macroeconomic indicators continue

The driver of the adjustment in US interest rates is related to the recovery in the economic data. Our view is that the massive easing of global monetary and fiscal policy is the key factor underpinning the rebound in macroeconomic indicators. To date, only partial removal of this stimulus has taken place and for the most part this has been in the smaller economies, such as Australia, where the Reserve Bank has raised short term interest rates three times, from 3.0% to 3.75%. Here in the US the Fed continues to signal a no change in rates for a considerable time ahead, while there are calls for further fiscal stimulus.

In our view, banks look at risk to downgrades due to recent legislation

Investors have also had to deal with another change in the dynamics impacting banks. The politics have changed. Markets had been long bank risk on the basis of banks being too big to fail + loads of liquidity. However, the fallout of the Democrat loss in Massachusetts has seen President Obama announce a new direct tax on wholesale liabilities (to claw back TARP); attempt to restrict bank proprietary trading; and, most importantly, to impose 'too big to fail' legislation that essentially is designed to remove the implicit support that has been given to banks post-Lehman. The rating agencies have taken notice and we have seen S&P change its outlook for both Bank of America and Citigroup from stable to negative, implying that on a stand alone basis the current ratings are at risk. We see ratings downgrade risk for Goldman Sachs, Morgan Stanley, Bank of America and Citigroup, though this will depend on if and when the bank reform legislation gets passed. If the rating of these banks are downgraded even 1-notch, all would lose their A-1 short term rating which would create problems for their access to the Commercial Paper market.

Our overweight to banks was a benefit to performance

In credit spread terms, financials vs. corporate bonds hit a historic wide of 243 bps in Q1 2009 (source: Barclays). Strategically, we were positioned for financials to outperform based on the long bank risk analysis outlined above. This spread has collapsed to around 50bp at present. We have reacted to the above change in politics for banks by significantly reducing bank exposure in favor of corporates (Industrials/Utilities).

4th Quarter earnings generally above consensus as corporations are lean

Our move to a higher corporate weighting in credit mandates is receiving strong support from the earning season. So far the US is witnessing roughly 77% of companies beating expectations and 21% missing on Q4 EPS and 71/29% on revenues. Guidance remains cautious but the corporate sector looks lean and mean and positioned to benefit from economic recovery. The ISM data, particularly the new orders component, suggests that the rebound in industrial production is gaining momentum.

Fiscal deterioration and higher deficits may lead to lower growth and rising interest rates

However, for the US and most of the G20 the long term impact of fiscal deterioration may be higher taxes. The process of getting budgets and debt under longer term control will be painful and the net result is likely to be slower growth than would otherwise have been the case. Our concern over longer term growth is compounded by the historical precedent that suggests rather unambiguously that rising deficit/GDP ratios may push interest rates higher over time.

Conclusions

Fixed Income markets have rapidly pushed towards fair value, given the macro headwinds

The challenges facing asset managers are significant, as asset classes have been driving towards fair value faster than we expected given the macro headwinds. We have argued credit remains in the sweet spot. However, we see the landscape evolving and while we remain overweight credit we have made significant 'tweaks' within our construction. In the short term, risk markets will be buffeted by sovereign risk and while we are prepared to trade this driver in the short term we are preparing for the fiscal deficit theme to hang around for some time to come.



Even with the current risk aversion, our bias is for higher rates through 2010

We have advised several times in recent months over the need to manage duration. While rate markets have done well of late we believe ultimately investors will be dealing with significantly higher rates than where we are currently operating. These adjustments, as southern Europe is finding out, are often quick and brutal. For now we are keeping our powder dry. **Again, for the record, we believe at some stage the various factors that are working to keep real bond yields near historic lows will evaporate and we will then witness a sharp rebalancing with the result being substantially higher level of rates.**

Portfolio Positioning and Strategy

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

We are more strategically underweight duration, current risk aversion aside, due to our bias for higher rates during 2010

Duration: Below benchmark. We remain modestly underweight duration as more of a strategic positioning, given our bias for higher rates over the course of 2010. Treasuries remain well within the range since June of last year. Our view, with continued improvement in sentiment and expectations, is we may test the top of this range in the first half of 2010, which would be 4% for the 10 year Treasury. While short term rates currently remain well anchored by an accommodative Fed, real rates in the intermediate and long end of the maturity spectrum may rise over the course of the year due to supply/demand pressures, rather than inflation concerns, which remain structurally benign.

We are neutral on the curve

Yield Curve: Neutral. The whipsawing of Treasury yields in December/January left us with limited yield curve trading opportunities as a trend following manager. While sovereign risk may contain yields in the short term, we believe with an accommodative Fed and supply/demand pressure we will continue to underpin record steepness in the yield curve. Our view of the curve will change with expectations of a tightening of Fed policy, which in our view will see bear flattening as short term rates are adjusted upwards.

We favor spread sectors (CMBS & MBS) over Treasuries

Treasury and Agency: Underweight Treasuries, neutral/underweight Agencies. We continue to underweight Treasuries and Agencies in favor of higher yielding asset classes (i.e. Agency MBS, Corporate, CMBS). Treasuries are back square in the middle of the trading range, and we remain strategically bearish towards rising rates through 2010. We see real rates rising and inflation continuing to trend lower. In our view, the key level to watch remains 4% for the 10-Year Treasury and at this level, we expect to evaluate a more severe underweight Treasury position.

We are overweight high coupons and underweight lower coupons, where Fed/Treasury purchase programs have been the most pronounced

Agency MBS: Overweight. Within Agency MBS, which has been a substantial topic of late, we remain overweight the higher coupons and underweight the low coupons. The Agency MBS sector has become bifurcated, with the Fed/Treasury purchase program leading to overvalued dollar prices in lower coupon securities, while higher coupons are benefiting from benign prepayment speeds. We view the lower coupons as having significant extension risk, and we see value in higher coupons as their high cash flow yields and relatively low durations provide optimal carry per unit of duration. That being said, we are monitoring the evolution of buyouts on the prepayment speeds on 6% and 6.5% coupons.



Corporate bonds underperformed for the first month in nine as risk aversion returned

Corporate Bonds: Overweight. With the year of credit behind us, Corporate bonds, even with their longer durations, underperformed in January in a significant Treasury rally. As discussed in the commentary, we benefited from our overweight to banks in the sector and have trimmed that position in favor of utilities and industrials. We remain overweight Corporate bonds and we believe continued macroeconomic improvement leaves the sector in the "sweet spot" while the Fed continues to focus on high stimulus. That said, the period of rapid spread compression may be nearing an end and our focus remains firmly on bottom up name selection for strategy outperformance.

The CMBS overweight is one of structure overcoming fundamentals

Structured Credit: Neutral ABS, Overweight CMBS: Rapid spread compression in the ABS sector and relatively low weighting in the Aggregate Index has us favoring Corporate bonds over ABS. We continue to increase our overweight to CMBS securities as the structures of bonds overcomes, in our view, the continued risk of a prolonged commercial real estate downturn. Within CMBS we carry much of our overweight in the AAA senior securities, which in our analysis have favorable total return potential due to structural enhancements and credit support. In addition to senior AAA CMBS, we have found value in selective purchases of mezzanine bonds from seasoned transactions where underlying collateral characteristics and structural integrity warrant.



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