# Macquarie Allegiance

Fixed Income Commentary | August 2010

## Not too cold, not too hot

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2010 is proving to be a great year for fixed income. For the year, the Barclays Aggregate Index is up 7.8% at the end of August. This compares favorably with equity markets, which remain in negative territory, around 4% through August. The surprise for fixed income investors has been the performance of Treasuries, where yields plunged below 2.5% on the 10-Year Treasury for the first time since December 2008.

*Treasuries were the surprise performer YTD*

**Table 1: YTD Index Returns through August**

| | |
|---|---|
| CMBS | 16.84% |
| Emerging Market Sovereign | 12.26% |
| Corporate | 10.01% |
| Treasury | 8.72% |
| High Yield | 8.27% |
| Aggregate | 7.83% |
| ABS | 7.06% |
| Agency MBS | 5.51% |

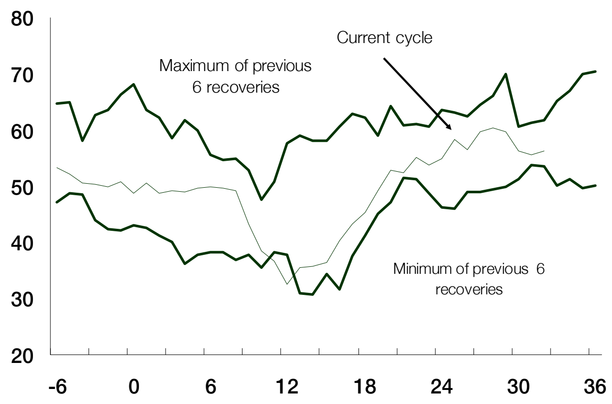
Source: Barclays

*The economic cycle will be pivotal for fixed income in the months and quarters ahead*

With the Federal Reserve holding rates near zero there is an environment being created encouraging investors to chase yield. However, this only makes sense if the economic environment matches this desire for yield. To date the rally in fixed income has been supported by: (i) a combination of low inflation and modest growth; (ii) stronger growth outside of the US; and (iii) a healthy corporate sector that has enabled credit spreads to tighten.

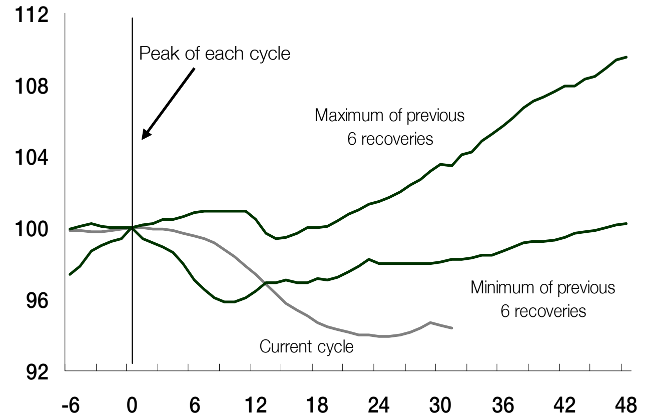
Significant debate has taken place over the summer as to the risk of the US economy entering a double dip recession. This is a key risk for asset markets going forward and therefore for our fixed income investment strategy, so lets take a look at the facts.

***Fact 1, the ISM cycle shows an average recovery***




Source: Institute for Supply Management

***Fact 2, the payroll cycle shows a very weak recovery***




Source: Bureau of Labor Statistics

**Fact 1:** The ISM survey continues to print within the range of previous recoveries.

**Fact 2:** Growth in Payroll employment remains significantly below the minimum achieved in previous recoveries.

**Fact 3:** The rebound in Retail Sales is below the minimum achieved in previous recoveries.

**Fact 4:** Inflation pressures are subdued.

***The lack of job creation continues to be the Achilles heel of this recovery***

In summary, US growth is weak and inflation subdued. Of particular concern is the lack of job growth and this matters as consumer spending makes up roughly 70% of US growth. The Obama administration is considering another (more targeted) fiscal stimulus, a potential "October Surprise", but the private sector is key to a sustainable improvement in the jobs market.

***The rise in M&A activity stands in contrast to the lack of private sector job creation***

The lack of private sector job creation seems to contrast the recent increase in M&A activity. However, the rise in M&A could likely reflect a unique combination of circumstance (such as low funding costs, robust improvement in profits, high cash levels and relatively cheap valuation) rather than a direct call on the economic cycle. Obviously, there is a risk with M&A that in their search for economies of scale the net result is job shedding.

So, the question haunting the politicians as they head into the mid-term elections is where is the engine for economic growth?

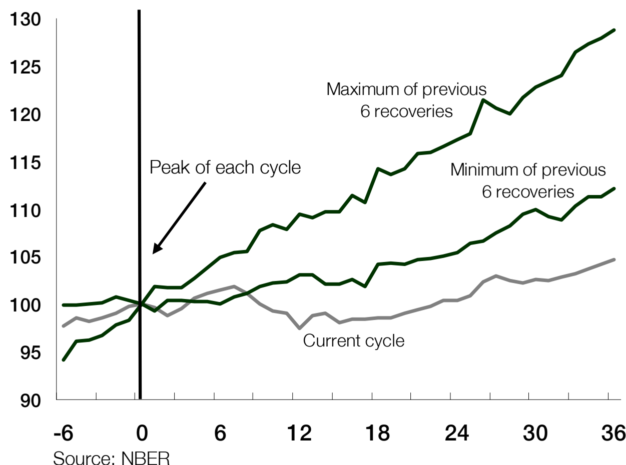
***The debt overhang for the government and the consumer is a long term drag on growth***

At its core this financial crisis has been about debt. The banks were full of bad debt and the consumer was highly leveraged. The banks have transferred their bad debt to the government, so the debt has not gone away….now the taxpayer has to pay! This is at the same time the taxpayer is under pressure from their own balance sheet (no jobs, lower house prices and lower equities). This explains why consumer spending remains subdued relative to previous cycles…and should continue for some time to come. Thus, the debt overhang, from both the government and the consumer, will continue to drag on growth for some time to come.

***Monetary policy may remain accommodative for many years***

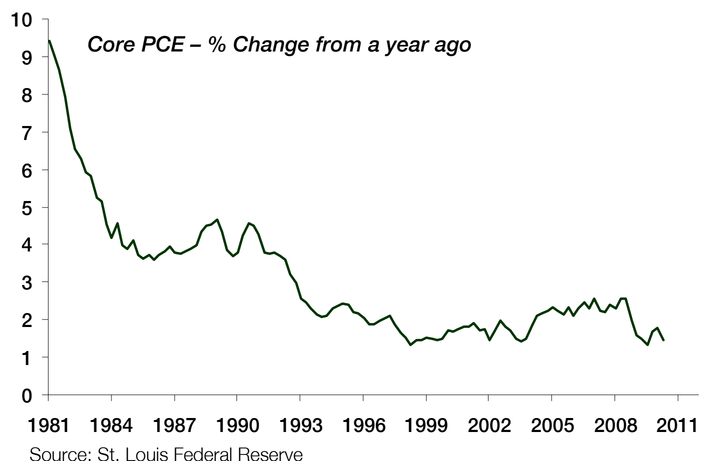
The good news is Fed Chairman Bernanke, gets it. In his recent commentaries the Fed Chairman has sent strong messages the Fed remains ready to act (on further easing) and that now is not the time to begin withdrawing fiscal stimulus. The Fed's action to buy Treasuries in August has been a contributing factor to lowering the structure of interest rates, but also in the steady rise in the mortgage applications index.

***Fact 3, Retail sales showing far below average recovery***




Source: NBER

***Fact 4, Inflation is low and expectations subdued***




Source: St. Louis Federal Reserve

*A double-dip is a matter of opinion, we are focusing on the facts*

So, at present the economic data is pointing to an economy that is not too cold, but nor is it too hot. We have not tried to answer the debate over whether the US will experience a double dip recession or not, that is a matter of opinion. What we are dealing with are the facts and it is on these facts we must make our investment strategy.

**Investment strategy**

*Our valuation models remain favorable to credit*

We have and continue to hold a positive outlook for credit. Our valuation models show Investment Grade credit is still one standard deviation cheap to history. Perhaps more importantly, our cyclical valuation model shows investment grade credit is cheap relative to the current cyclical indicators (see chart below). From a bottom up perspective, credit analysis is very positive on the corporate sector, supported by high cash levels and falling default risk.

*We remain positive on credit but risk limits are lower due to volatility and technical factors*

All that said, the technicals surrounding credit are causing volatility. Our weekly scorecards (that we use to review all the drivers of each asset class) remain in positive territory (suggesting we remain long credit) but the scores have been volatile on a week-to-week basis. This reflects factors such as the price action in equities and regular spikes in equity volatility. Additionally, our process is capturing the negative influence of rising spreads in EU sovereigns.

*Our process is indicating volatility will continue, but investors should be overweight risk assets*

The combination of positive fundamentals and cheap valuations but volatile technicals has caused our investment strategy to pursue a more cautious approach to credit markets in recent months. Unless the threat of a double dip recession materializes, we will look to selectively add credit risk on dips.

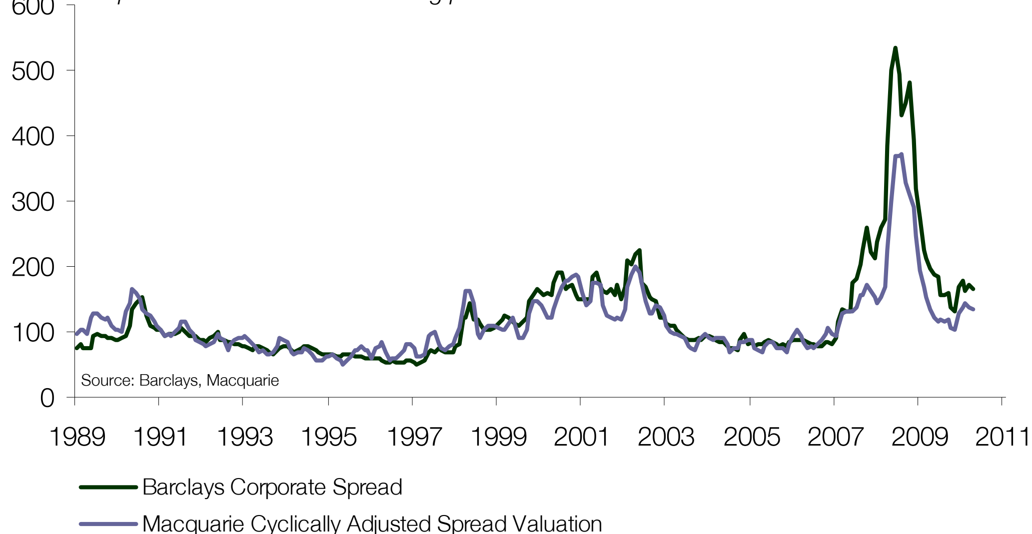
*Treasury yields have surprised in their total returns YTD*

In regards to interest rates and duration, Treasuries have been the surprise asset class within fixed income. Since April's peak in yields, Treasury's, on the back of falling inflation, general risk aversion and quantitative easing have seen yields melt to record lows in short maturities. In most cases Treasury yields are back to levels that operated in the dark days of the post-Lehman crisis.

*Treasury yields look to remain low for the foreseeable future*

In valuation terms, Treasury yields are over-valued to historicals, but not to the extremes that existed in December 2008. In the short term, the ISM and NFP data has given hope the economy is indeed back on track. Thus, it would be no surprise for September to witness a correction higher. However, strategically, in the absence of any inflation threat the yield curve looks to flatten further. Until the fear of deflation is removed, we suspect investors will be reluctant to dump Treasuries.

*Our fundamental models show a positive valuation gap for Investment Grade Corporate bonds*



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***The backdrop remains positive for all fixed income sectors***

**Bottom-line:** Weak growth, benign inflation and a on hold Fed continue to give support to risk assets and Treasuries alike. The combination of volatile economic data and the "unusually uncertain" outlook warrants the evaluation of all high frequency data cautiously. With this backdrop our process and scorecards continue to find value in credit related sectors, see limited risk of substantially higher Treasury yields, and look for the yield curve to flatten further. The mid-term elections and any "October Surprises" are on our radar, and those should become more clear through September.

**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.*

***Treasury yields look to remain low for an extended period***

**Duration:** *At benchmark.* We continue to maintain a benchmark duration as technical and fundamental measures signal to us there is limited risk of substantially higher Treasury yields over the next 3-6 months. Interest rates look to remain low for the foreseeable future as a sub par recovery and accommodative monetary policy will keep demand high for Treasury bonds.

***The trend remains for the yield curve to flatten further, accelerated by quantitative easing***

**Yield Curve:** *Flattening.* The trend in the yield curve has continued to be flattening amidst the weak data, benign inflation and quantitative easing. In August, the announcement by the Federal Reserve to beginning purchasing Treasuries saw immediate effects in intermediate yields. Our trend following approach and technical signals continue to advocate further flattening of the yield curve may be expected.

***Agency valuations are poor relative to Treasury's***

**Treasury and Agency:** *Overweight Treasuries, underweight Agencies.* Technicals in the Treasury market, a core component of our investment process, continue to signal limited risk of substantially higher Treasury rates over the next 3-6 months. We remain underweight Agencies as relative valuations are poor (Spreads are below their long term average) and we are cautious towards any changes or reforms announced regarding the GSE's that may affect valuation.

***We have significantly reduced our overweight to Agency MBS***

**Agency MBS:** *Neutral.* We have reduced our exposure to Agency MBS over the past three months as valuations have moved higher and there is uncertainty surrounding any reforms or "October Surprises" directed at the GSE's. In our view, any reforms may result in higher pre-payment rates leading to lower valuations in the sector. The core of our Agency MBS exposure remains within low coupon MBS, where in our evaluation, prepayment risk is limited.

***From a bottom up credit analysis, corporate fundamentals are strong***

**Corporate Bonds:** *Overweight.* Corporate Bond valuations remain attractive, in particular when evaluated at a bottom up level with corporate fundamentals (debt to cash flow, asset coverage). Recent new debt issuance has also confirmed these fundamentals, for example Johnson and Johnson's record 10 year bond yield was only 43 basis points above Treasury's. While we have reduced our credit exposure our scorecards and process are indicating we will be looking to increase exposure to risk assets over the next few months.

***The CMBS sector continues to be the top performer of the year***

**Structured Credit:** *Neutral ABS, Neutral CMBS:* We significantly reduced our overweight to CMBS in August due again to our process and scorecards indicating volatility in the capital markets. CMBS have been one of our favored sectors for the year and remain attractive, but with much lower total return potential than at the beginning of the year. We look to increase our weighting in CMBS primarily in the more liquid AAA-only CMBS.

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