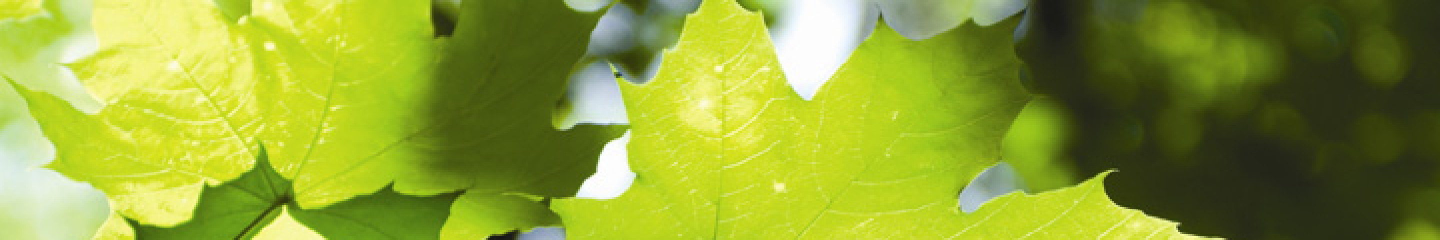

Macquarie Allegiance

Fixed Income Commentary | March 2010

Fundamental matters

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Head of Global Strategy
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The US and Global recovery theme has strengthened and broadened according to the most recent economic data. Purchasing Manager Index (PMI) data around the globe, except for Greece, is above 50. Financial markets are now keenly awaiting the earnings season, which will kick off in mid-April, where focus will be on the outlook/guidance from the micro perspective. This backdrop encouraged investors back into risk mode during March.

Our surprise index confirms better than expected data - a positive trend for risk markets

In our scorecard investment process, one of our favorite methods of tracking the trend in the macro picture is with a Surprise Index, that is, a measurement of how actual data comes out relative to market expectations. Within this analytical technique there are two ways of observing the macro picture: (i) the change in 10 Year yields relative to the Surprise Index; and (ii) the level of 10 Year yields relative to the Cumulative Surprise Index (CSI), this is essentially adding up all the surprises. Both of these relationships are illustrated below on charts 1 and 2.

With better than expected data, Treasury yields approached the important psychological yield of 4%

Chart 1 shows quite clearly that there is a strong directional relationship (correlation) between the trend of the Surprise Index and the change in 10 Year yields (a relationship that held through the turmoil of 2008-2009). Equally, chart 2 shows there is a directional relationship between the level of 10 Year yields and the CSI. It can be observed that on average, the actual 10 Year yield is more volatile than the CSI, which makes sense as it will be influenced by a range of non-economic factors such as flight to safety or supply. However, what is key to note is that the trend in data beating expectations appears to have a direct influence on the direction of Treasury Yields and that deviations are not sustained for long periods.

Unemployment and housing, missing components for a change in Fed policy

This brings us back to the here and now. After the strong move from the end of 2008 the CSI trend has been consolidating since September 2009. However, it has threatened to break higher and in March this break is confirmed. The implications are that the recovery may be broadening and deepening. If true, this significantly reduces the tail risk of the bond bulls – the double dip recession. US 10 Year yields have risen to retest their cycle peak of 4%. Technically and psychologically 4% yield on the 10 Year is a major level. The macro outlook, evidenced by the trend of the CSI, is pointing to the prospect of higher yields. The latest Fed minutes give us the roadmap - once housing and employment turn decisively, policy may be tightened.

Chart 1: There is a clear directional relationship between the trend in the Surprise Index and the change in 10 Year yields.

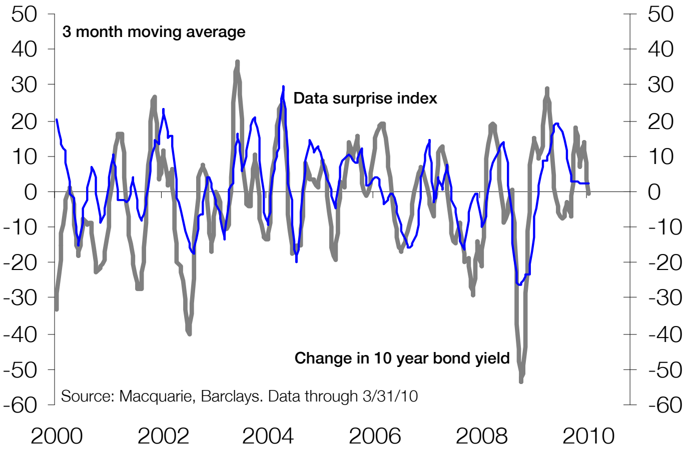
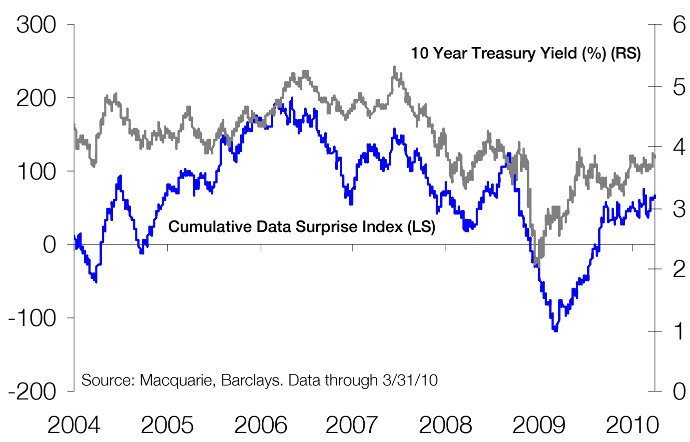


Chart 2: The CSI measures the cumulative trend in data surprises, and exhibits a strong correlation with the direction of the 10 Year Treasury.



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Managing duration risk in 2010 may drive returns, in our view

In our January publication, we stated that 2010 may be the year of duration and have warned clients of the need to manage duration risk. The Barclays Aggregate Index has recently delivered two months of negative returns: -1.56% in December 2009 and -0.12% in March 2010. These negative returns are being driven by duration, as 5 Year Treasury yields have risen 54bp from the end of November to the end of March, while the Barclay's Corporate Index has actual spreads tightening from 172bp to 150bp over the same period.

So, fundamentals matter. This is why we are very attentive to the trend of recent economic data.

Structural inflation may be low, but real bonds yields are not providing compensation against overvaluation

In regards to inflation, many analysts are taking comfort from the fact inflation pressures remain subdued. This is supported by very low levels of capacity utilization and the decline in average earnings, to just 2.1% in March (Source: BLS). Despite these facts we hold the view US real yields are simply too low. Charts 3 and 4 have been shown before, but I believe it is worth illustrating the point again. Chart 3 compares US 2-Year Treasury yields against the trending CPI inflation (using the 5-year moving average). Chart 4 compares US 10-Year Treasury against trending inflation. The most recent data (using the consensus forecast for March CPI) shows that 2-Year Treasury yields are 350bp expensive and 10-Year Treasury yields 135bp overvalued, against trending inflation.

Treasury yields are headed higher, it is a question of timing, one that may well be a 2011 event

We use these valuation measures in a longer term context. The message though is clear. We believe, US bond yields are heading higher, much higher. The US yield curve should flatten, in our estimate around 200bps (as of 3/31 2/10's difference was 281bps), as the cycle of higher yields unfolds. The question is of timing. Substantial economic slack, structurally high unemployment and a Fed Chairman whose academic work has been on the premature removal of stimulus lead us to view the timing to be unknown and potentially a 2011 event.

We enter 2010 overweight credit risk and underweight duration risk

What is known, in our view, is portfolio positioning today for these events is warranted. Absolute low yield levels in short maturities coupled with the bond market's history of jumping the gun on Fed rate hikes is our rationale for this approach. Historically, the bond market has been premature in pricing in rate hikes and short maturities are susceptible to this, igniting a flattening yield curve in response. We enter the 2nd Quarter overweight economic risk (credit risk) and underweight interest rate (duration) risk. We are monitoring signs from our fundamental and technical scorecards to prepare for a flattening of the yield curve.

Chart 3: 2-Year Treasury yields against trending inflation are overvalued, and vulnerable to any change in Fed policy.

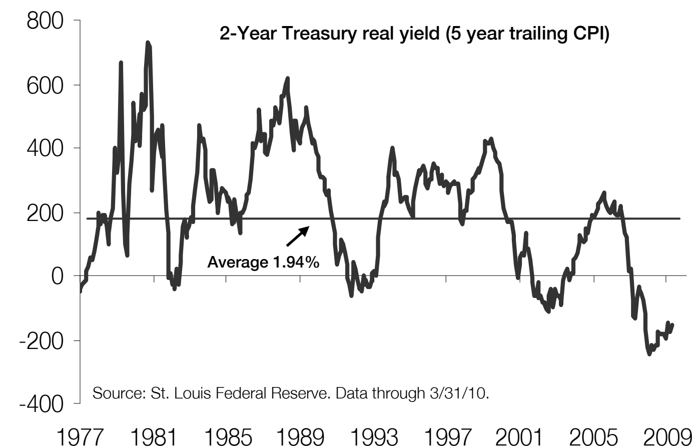
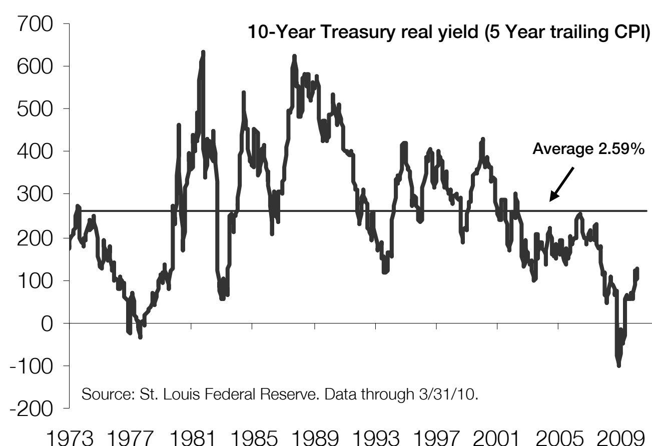


Chart 4: 10-Year Treasury yields have corrected from extreme overvaluation, but are still below historical averages.



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.

Strategically underweight duration

Duration: *Below benchmark*. We are strategically underweight duration, given our bias for higher rates over the course of 2010. While Treasuries remain well within the trading range established since June of last year (3.3-4% for the 10 year Treasury), technical indicators are flashing a test of this range. The 10-Year Treasury range looks to be tested as rates moved towards the psychologically important 4% barrier at month end.

History tells us the next move in the curve may be a flattener

Yield Curve: *Neutral.* A well anchored Fed, along with Sovereign risk for many countries, may contain yields in the short term but in our view any change in Fed policy will lead to a substantial flattening of the yield curve. History tells us such, during the 1994 and 2004 tightening cycle's, the yield curve, on average, flattened by 0.83% between the 2-Year and the 10-Year Treasury (source: Barclays). While we remain neutral on any tactical positing, we closely monitor our fundamental and technical signals to prepare for a flattening of the yield curve.

Treasuries are range bound and Agency spread levels are unattractive. Watch for a break above 4% on the 10 Year Treasury.

Treasury and Agency: *Overweight Treasuries, neutral Agencies*. While we continue to strategically favor higher yielding asset classes (i.e. Agency MBS, Corporate, CMBS), current poor valuations in Agencies leave us overweight Treasuries at month end. This overweight in Treasuries is primarily in one year or less duration securities, where we carry a substantial overweight. Treasuries are pushing back towards the top of the trading range and as discussed within our commentary, continued improvement in trend economic data may challenge this range. In our view, the key level to watch remains 4% for the 10-Year Treasury.

Reduced up-in-coupon positioning as the buyout program filters through the markets

Agency MBS: *Overweight.* The GSE Announcement to buy out 120+ days delinquent loans in February has led us to re-position our strategic up in coupon allocation as the volatility associated with pre-payment risk filters through over the next few months. We have reduced our up-in-coupon overweight and increased our exposure to lower coupon Agency MBS. We view this as a short term detour from our strategic view that within Government fixed income, high coupon Agency MBS may provide one of the best risk/return profiles.

Corporate bond spreads over Treasuries continue to move tighter

Corporate Bonds: *Overweight.* In our view, Corporate bonds remain attractive within the Investment Grade universe of fixed income. 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 a high level of 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.

CMBS continue to outperform, as structures overcome fundamentals in the sector

Structured Credit: *Neutral ABS, Overweight CMBS:* We continue to increase our overweight to CMBS securities as the structures overcome, 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 find value in selective purchases of mezzanine bonds from seasoned transactions where underlying collateral characteristics and structural integrity warrant.

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