

# Fixed Income Market Commentary and Strategy Review

Fourth Quarter 2011



A Virtus Investment Partner

## FIXED INCOME 2011 MARKET REVIEW

Despite our long held view that the recovery from the *great recession* would be a weak one, we entered 2011 with some optimism. By late 2010, the aggressive policy actions implemented in 2009 had lifted the world economy out of recession, propelling US GDP growth to 3.1%, and Germany enjoyed a 3.6% GDP increase, the best in 20 years. China bounced back strongly after the crash as well, as massive stimulus produced 11% growth, up from mid-single digits in 2009. We expected this momentum to continue into 2011, led domestically by the manufacturing sector and internationally by emerging markets. The view was validated early in 2011, as US manufacturing ISM grew at one of the highest rates on record [See Figure 1]. Also in the first quarter, the Fed's senior loan officers' survey indicated that lending conditions were improving, a sign of economic expansion.

This scenario began to unravel later in 2011 as a series of unexpected events shook the world economy, pushing risk markets lower. January's optimism about the political changes occurring in Egypt and the Maghreb was soon tempered by concern about the "Arab Spring's" potential impact on energy markets. In March, the Japanese tsunami and subsequent reactor meltdown badly disrupted global industrial supply chains and impeded economic growth. The West had its policy problems as well, as the EU fumbled with the hard choices necessary to rectify the debt problem on its periphery, and the US turned a simple debt ceiling adjustment into an existential crisis.

The result was a dramatic slowdown in economic growth mid-year, with plummeting global PMI [See Figure 2] readings emblematic of weaker manufacturing and flagging confidence. In the US, GDP fell to a low of 0.4% in the first quarter [See Figure 3], and nonfarm payroll growth dropped to near zero in June. In Europe, the July decision to impose a restructuring on private Greek debt holders shattered the perceived sanctity of Eurozone sovereign credit, creating a run on the

**FIGURE 1. U.S. ISM MANUFACTURING INDEX**

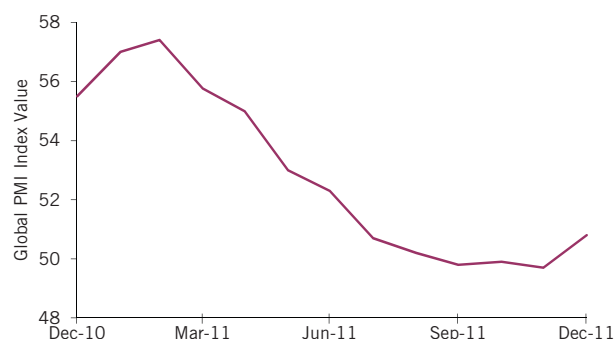
December 31, 2000 to December 31, 2011



Source: Bloomberg

**FIGURE 2. GLOBAL PMI**

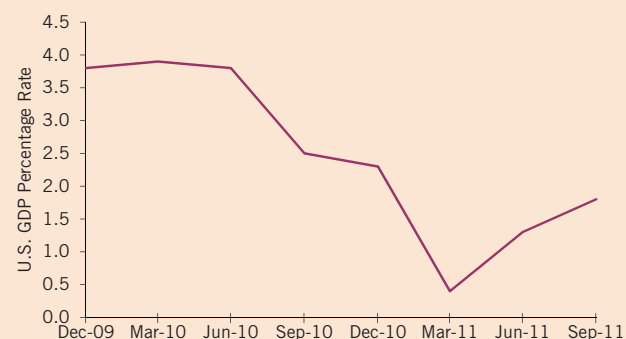
December 2010 to December 2011



Source: JP Morgan Global Purchasing Managers Survey 2011

**FIGURE 3. U.S. GDP**

December 2009 to September 2011



Source: Bloomberg

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**FIXED INCOME MARKET REVIEW (CONT.)**

debt of the rest of the European Periphery. In a flash, Italy's 10-year debt yield exploded from less than 3% to greater than 7%, and the debt of the other peripheral countries followed suit [See Figure 4].

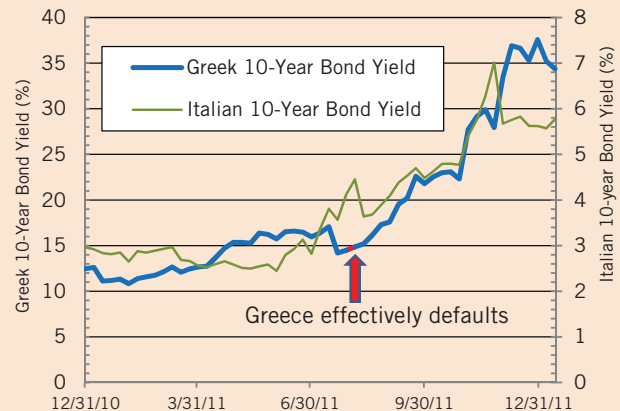
The crisis was a wakeup call for Europe's leaders and set in motion a series of policy initiatives that culminated in an EU mandate for tough fiscal discipline accompanied by monetary support in the form of a long-term funding facility for banks that broadly expanded the role of the ECB. The prospect of a European fiscal union supported by the ECB boosted investor confidence and helped stabilize world markets by year end. The Federal Reserve acted aggressively as well. It initiated an aggressive debt maturity extension program in its Treasury portfolio, extended unlimited dollar

All markets will benefit from less European volatility. And the developed world will profit from the extraordinary monetary impetus provided by the world's four largest central banks.

swap lines to foreign central banks, and asserted the Fed's intention to pursue further extraordinary measures (QE III) should economic weakness persist. The combined impact of these policy initiatives was constructive for risk markets, which rebounded strongly throughout the fourth quarter. During the quarter high yield bonds were the top performing fixed income category, up 6½% Q/Q while Treasuries effectively ground to a halt. Over the full year however, the best performing assets were of the risk-free variety, with the flight to quality driving US Treasury prices up 10%. [See Figure 5].

**FIGURE 4. GREECE VS. ITALY - 10 YEAR BOND YIELD**

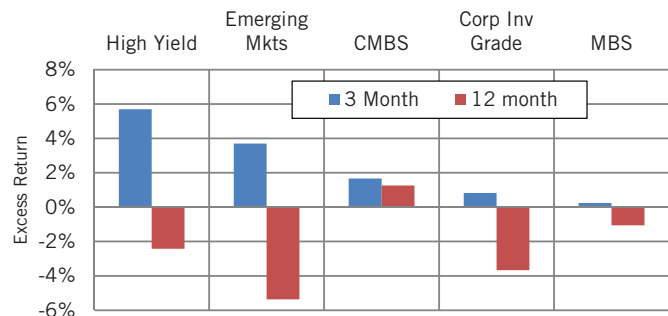
As of December 31, 2011



Source: Bloomberg  
10 year sovereign yield comparison

**FIGURE 5. SPREAD SECTOR PERFORMANCE COMPARISON**

4q11 and 2011 Performance - as of December 31, 2011



Source: Barclays Capital

**2012 MARKET OUTLOOK**

We expect 2012 to be a modest improvement over 2011, though markets will continue to wrestle with the dichotomy between a recovering US economy and disparate negative forces on the international front. World markets will be underpinned by a continuation of the policy accommodation that boosted returns during the fourth quarter. The US economy will benefit from the strong financial condition of its private economy and election year political pressure to boost domestic growth. Europe's debt crisis will push the EU economy into recession, but will also elicit a forceful and credible policy response that should be sufficient to prevent a systemic crisis.

**FIXED INCOME MARKET OUTLOOK (CONT.)****US OUTLOOK**

In the United States, stimulative economic policy will prevail for the foreseeable future. Since the financial crisis, the Federal Reserve has been resolute in its willingness to reflate the economy, and in 2012, the FOMC becomes even more dovish, as the most hawkish FOMC members are retiring. On the fiscal side, election year politics should also dictate economically expansive policy actions. In the real economy, corporate profitability remains strong [See Figure 6] and the financial condition of American companies is solid. With these tailwinds already in place, US economic data has been accelerating. The manufacturing sector is picking up again, and employment (the most intractable casualty of the recession) has begun to improve. Indeed, December nonfarm payroll jumped by a surprising 200,000 [See Figure 7]. As a consequence, we expect inflation to equal or even exceed the Fed's 2% inflation target as economic slack recedes and monetary aggregates grow.

**INTERNATIONAL**

Once again, all eyes will be on Europe in 2012, so we will spend some time on the subject. The European debt crisis still presents the biggest risk to global economic growth and a disorderly collapse of the eurozone would inevitably reverberate worldwide. Policymakers have learned a lot from the 2011 experience however, and are stumbling inexorably towards a solution. In order to succeed, they will need a mechanism that ensures permanent discipline over the fiscal behavior of each Eurozone member state. On December 9, Germany and France took several meaningful steps in this direction and are expected to provide more detail during Q1. The institution of this "fiscal federalism" will take time to achieve, as 17 national governments must institute the requisite constitutional reforms. Europe has no other choice however, and we expect that they will ultimately achieve adequate control over their fiscal imbalances.

The markets are impatient however, and a lender of last resort is needed to provide a bridge that can keep the union liquid while it struggles to become solvent. The ECB is the obvious entity to fulfill this role. The ECB took a huge step in this direction recently by providing a liquidity bridge to Europe's banks without incentivizing profligate behavior. They

**FIGURE 6. PROFIT MARGINS**

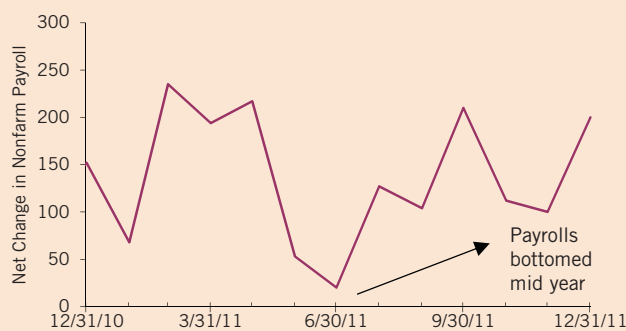
1991 to 2011



Source: Morgan Stanley

**FIGURE 7. NET CHANGE IN U.S. NONFARM PAYROLL**

December 2010 to December 2011



Source: Bloomberg

did this by initiating a three-year bank financing program (Long Term Repurchase Operation or LTRO) that is a form of stealth quantitative ease in which, rather than purchasing sovereign debt outright (as the Fed does Treasuries), the ECB loans banks cash against sovereign collateral. This cleverly removes distressed sovereign debt from the market and replaces it with cash in the form of excess reserves. These excess reserves become an impenetrable bulwark against liquidity demands which otherwise might become systemic.

The value of this facility to financial markets cannot be underestimated. It has already taken pressure off of funding markets (a major source of market stress) by providing almost limitless access

**FIXED INCOME MARKET OUTLOOK (CONT.)**

to liquidity. They expand the ECB's balance sheet, effectively introducing massive quantitative ease to the Eurozone. This will be immensely positive for risk markets, similar to the performance of the S&P in the US during QE I and QE II [See Figure 8]. However, we do not think the continent is of the woods yet. That will not happen until solvency for Italy and Spain is assured, but we do believe that systemic tail risks associated with the European debt crisis have diminished substantially. Additionally, it's important to recognize that the Mario Draghi's ECB is a much different entity than it was with Jean-Claude Trichet at the helm. Draghi has proven himself to be creative and aggressive, something that could not be said of Trichet. As a consequence, it seems reasonable to expect a larger monetary contribution from the ECB in 2012. As a result, we expect a moderate recession in Europe, not an economic meltdown, less volatility, and sufficient breathing room for the fiscal authorities to craft a long term solution.

**DEVELOPED WORLD**

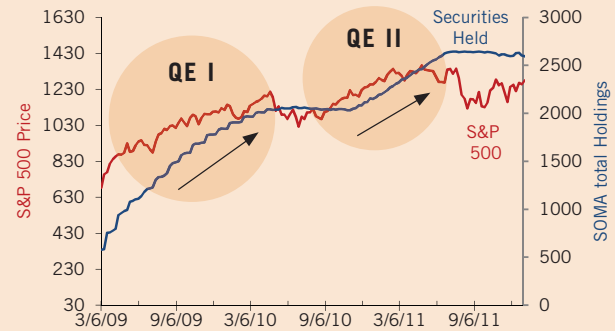
All markets will benefit from less European volatility. In addition, the developed world will profit from the extraordinary monetary impetus provided by the world's four largest central banks: the Fed, the ECB, The Bank of Japan, and the Bank of England. Together, the four CBs have more than quadrupled their combined balance sheets in the last five years, growing to \$14 trillion in US dollar equivalents. This massive extension of monetary assistance is roughly equal to US GDP, and 35% of the equity market cap of the entire world [See Figure 9]. This profound monetary tailwind will not only propel risk markets, but should also be a significant contributor to developed world economic growth.

**EMERGING MARKETS**

We are less sanguine about the emerging markets, which paradoxically, may be the biggest victims of Europe's distress. Clearly, recession in the EU will hurt them through the trade channel, as EM export flows to Europe diminish. More importantly, emerging countries will suffer through the financing channel as well. This is because Europe is the banker to the emerging world, and due to recession and Basel III capital requirements, European banks will be shrinking their loan books. Emerging

**FIGURE 8. QE PROPELLED ASSET PRICES IN U.S.**

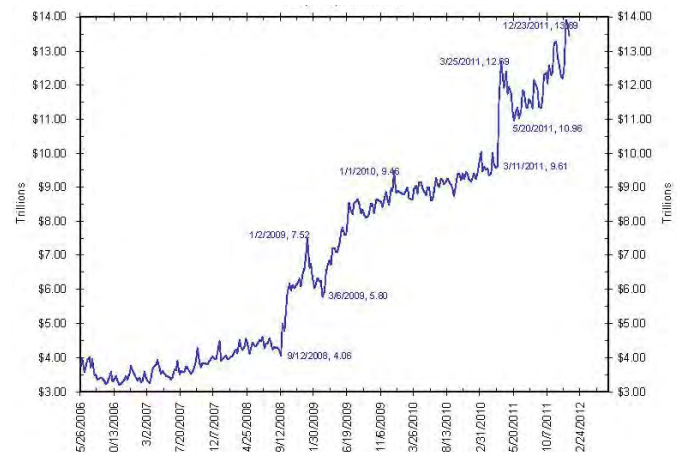
March 6, 2009 to January 13, 2012



S&P 500 vs. securities held in Fed's open market account  
Source: Bloomberg

**FIGURE 9. "BIG FOUR" BALANCE SHEETS IN TOTAL**

May 2006 to December 2011 - Fed, ECB, BoJ and BoE



In U.S. dollars.  
Source: Bianco Research

markets banks and manufacturers will be the first to feel the cutbacks, hobbling not only their trade with Europe, but their ability to do business elsewhere in the world as well.

Even the largely self-funded BRICs, whose large reserve balances insulate them from the funding squeeze, will be challenged this year. They stepped too hard on the gas in 2008-10, and responded to the overshoot by slamming on the brakes hard in 2011. We expect them to struggle in 2012 to find the middle-ground between policy accommodation and restraint.

**FIXED INCOME MARKET OUTLOOK (CONT.)**

**INVESTMENT POSTURE**

**Rates:** US Treasuries are one of the few investments still considered a “riskless” asset. Their value as a policy tool and as a safe haven investment has driven them to valuation levels that produce negative real yields when adjusted for inflation. The most prominent participants in Treasury bonds are therefore not value investors, but rather entities pursuing non-economic agendas, such as the Federal Reserve, the Chinese government, and nervous investors seeking refuge from their home markets. None of these entities cares what they pay for the bonds, and their demand for safety and liquidity will keep U.S. Treasury yields repressed. Given this dynamic, there is little point in trying to anticipate the direction of rates or the shape of the yield curve. As such, we will stay close to benchmark in portfolio duration. From a sector selection standpoint, Treasuries represent little value, and we will strive to find superior alternatives. Agency mortgage backed securities share many of the same characteristics as treasuries, and we will remain underweight that sector as well.

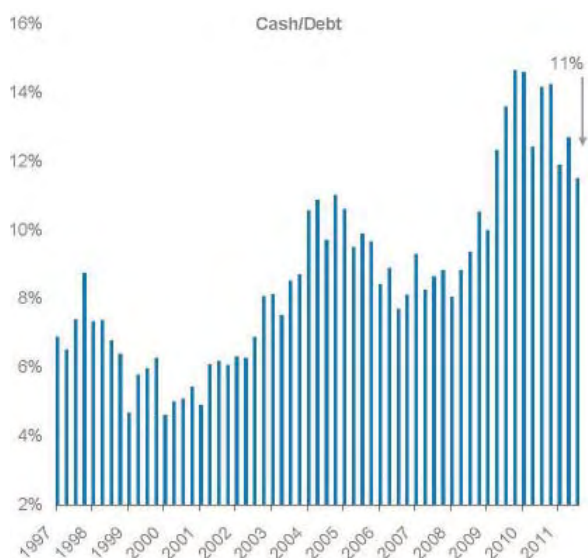
**Credit:** Fortunately, a rare confluence of factors, both top down and bottom up has combined to make credit instruments an attractive fixed

income investment alternative. From a bottom up perspective, credit fundamentals in non-financials are exceptional [See Figures 10 and 11]. The story is even more compelling for financials, where post-crisis regulatory imperatives make credit prudence a legal mandate. Through Europe’s Basel III framework and America’s Dodd Frank legislation, banks are now required to boost their equity capital, reduce the riskiness of their assets, and maintain deep cushions of liquidity to levels far higher than ever before. Shareholders have (rightfully) complained about earnings compression and EPS dilution but bondholders can celebrate what will be by law a low risk, highly capitalized industry with unassailable credit quality.

From a top down perspective, the macroeconomic environment favors credit as well. Since Ben Bernanke’s “credit easing” initiatives in 2008, aggressive central bank intervention has supported credit markets through both the funding and portfolio balance channels. With the ECB now in the game as well, credit markets should enjoy substantial incremental sponsorship. More prosaically, GDP growth in the 2% range has historically favored corporate bonds over stocks, providing ample earnings to cover debt service and modest inflation.

**FIGURE 10. CORPORATE CASH REMAINS HIGH**

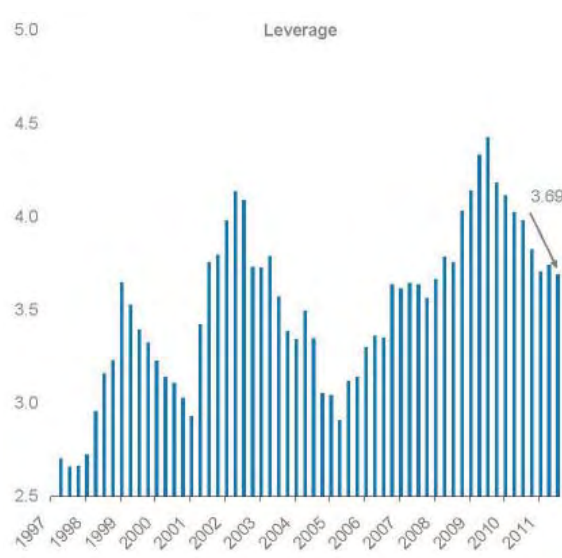
1997 through 2011



Source: Morgan Stanley, Bloomberg

**FIGURE 11. CORPORATE LEVERAGE IS DECLINING**

1997 through 2011



Source: Morgan Stanley, Bloomberg

## **FIXED INCOME MARKET OUTLOOK (CONT.)**

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### **CREDIT SECTORS**

The high yield sector should be the largest beneficiary of the investment environment we envision. The sector is extremely undervalued, as yields reflect recessionary default levels of near 10%, far beyond the current 2% default rate and our 4% projection for 2012. Recent mutual fund flows out of Treasuries and into high yield reflect the attractiveness of the sector and will continue to provide a significant technical tailwind. We will emphasize this sector in portfolios that permit securities rated below investment grade.

In investment grade credit, the financial sector is by far the most appealing opportunity. US and other Anglophone banks possess the regulatory benefits mentioned above, and also enjoy limited exposure to core Europe. The insurance industry can be characterized similarly. From a valuation standpoint, memories of the 2008 financial debacle have left a bitter taste in the mouths of investors, and the sector valuations remain subdued. There is significant upside from these levels and we are positioned to capture it.

CMBS also stands out as an opportunity in credit. The sector benefits from substantial structural credit support, improving asset quality, and one of the most compelling supply technicals in the market. Like our corporate credit picks, CMBS benefits from a recovering US economy, stimulative official policy, limited European exposure, and is a core overweight.

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### **SUMMARY**

Overall, we enter 2012 confident in the prospects for fixed income. Despite economic uncertainties in Europe and a raucous political season at home, we see numerous opportunities to add value for our investors. Policy accommodation should promote growth in the US economy and prevent a catastrophic outcome in Europe. There are manifold investment opportunities for fixed income investors in mortgage and corporate credit, and if 2012 plays out as we predict, we expect our clients will realize their full value.

### **NEWFLEET ASSET MANAGEMENT: ORGANIZATIONAL UPDATE**

Happy New Year! As you are aware, in June 2011, SCM Advisors LLC in San Francisco merged with Goodwin Advisors in Hartford, CT to create Newfleet Asset Management LLC with 27 investment professionals. This merger was established to provide comprehensive fixed income solutions to a diverse client base of pensions, corporations, Taft-Hartley, endowments, foundations, individual and retail investors.

As part of Newfleet's evolution, our private client and equity strategies have merged with our sister firm, Kayne Anderson Rudnick Investment Management (KAR), headquartered in Los Angeles since 1984. This change allows each firm to further leverage the talent, resources and strengths of their areas of expertise and uniqueness of each organization.

We are pleased to announce that the transition was a successful one and we look forward to providing a great future for our clients.



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