bond market review & outlook

By Thomas Fahey, Associate Director of Macro Strategies

first quarter 2013

The first quarter of 2013 turned out pretty much as expected: a low volatility environment with the level of bond yields and credit spreads relatively stable. At some point, we have to be happy with earning a yield on our fixed income investments. The last several years have been a major bond bull market, particularly 2012, but with yields at low levels, there is not much room left for bond price appreciation and we should be comfortable with earning our yield and carry.

Central banks around the world have worked hard to keep volatility low and to encourage portfolio rebalancing. Their mission has been a success so far, as we have seen asset prices rise, which has allowed collateral values to increase and enabled deleveraging the easy way—through the assets side of the balance sheet rising rather than the painful, deflationary cutting of liabilities.

Now, it would be great to see the real economy begin to drive growth, along with continued improvement on the asset side of the balance sheet. In other words, the real factors of economic production—land, labor and capital—become engines of growth driving rising profits and incomes. The old growth model of borrowing and spending is impaired, so we need more profits, jobs and incomes to move the economic expansion forward.

We are comfortable that the US economy appears to be on the right track, as profits have been healthy, leading to job growth and some income growth. But the UK and European economies are still struggling. Europe's unemployment rate hit a new high of 12% in February. The European debt crisis was back on with the Cyprus bailout hitting in March. Unfortunately, the crisis only goes dormant because the main cure is economic growth, which is severely lacking in Europe. Without GDP growth to drive the profits and incomes necessary to service the debt, an alternative is to hit some creditor with a loss, as we saw in Cyprus. That is deflationary and painful; therefore, Europe looks like a good inflation hedge, as we expect European economic growth to disappoint expectations. We expect that European bond yields will be anchored going forward, especially compared to US yields, which are expected to rise as the US economy gains traction.

The first quarter saw some changing correlations in the capital markets, the most significant being the way the US dollar has strengthened in conjunction with a strong US equity market. In the last decade, a strong dollar has coincided with a weak equity market and a risk-off environment. Conversely, a weak dollar was good for exporting easy Federal Reserve (Fed) policies to the rest of the world, and risky assets appreciated that phenomenon. So why is it significant that the dollar is stronger and the US equity market is rising? Because we see foreign central banks grabbing the baton and becoming even more aggressive than the Fed in their monetary stance. For example, the Bank of Japan (BoJ) made a vow to reach a 2% inflation target; the European Central Bank (ECB) stated it will "do whatever it takes to save the euro"; the UK government just expanded the remit of the Bank of England to be more flexible and aggressive with monetary policy. These more aggressive policy actions are a big part of why volatility has stayed low, even when considering significant events like Cyprus, and it is a major reason why the dollar is stronger and global equity prices are still rising. We anxiously await a more substantial pick-up in the real economy.

With central banks in action, we believe that a thirst for yield is going to drive fixed income and credit sectors for the next few quarters. Yields are low, but soft growth, low inflation and easy monetary policy suggest it could be a year of earning yield and carry.

RETURNS BY SECTOR[1] *as of March 31, 2013*

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US Broad Market				
Aggregate	0.08	(0.12)	0.09	3.77
Government/Credit	0.06	(0.16)	0.21	4.56
S&P 500®	3.75	10.61	10.19	13.96

The year started off with many investors feeling better about market conditions as the fiscal cliff disaster scenario was averted and fears about Europe moved to the back burner. Cash seemed to come in off the sidelines, with strong flows into both equity and fixed income funds. As the quarter wore on, Europe turned more worrisome and the growth outlook appeared more challenged for many countries, except the US. The US dollar rallied, leading to losses for many currencies. However, "risk on" paid off in equities, US high yield bonds and bank loans, and emerging market corporates. Investment grade sector returns generally included only modest increases and a few small declines.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US Governments				
US Treasurys	0.10	(0.19)	(0.27)	3.14
3-month T-bills	0.02	0.02	0.06	0.13
2-year Treasury	0.02	0.09	0.15	0.48
5-year Treasury	0.14	0.18	0.17	2.97
10-year Treasury	0.42	(0.31)	(0.54)	6.20
30-year Treasury	(0.17)	(3.07)	(4.31)	7.48
US TIPS	0.28	(0.36)	0.32	5.68
US Agency	0.06	0.06	0.18	2.26

Treasury performance disappointed this quarter with small gains for short-to-intermediate notes and outright losses for longer bonds. US economic data was generally better than expected, with improvements seen in the labor and housing markets. This and other considerations led investors to debate the possibility that the Federal Reserve might end its extraordinarily loose monetary policy sooner than previously expected. This put upward pressure on US Treasury yields; however, continued turmoil in Europe dampened the move. Inconclusive Italian elections in February and the Cyprus crisis in March reminded investors that US Treasurys still have perceived safe haven appeal, albeit with stingy yields. The yield on the benchmark 10-year Treasury began the quarter at 1.76% but ended it at 1.84%, after hitting an intra-quarter high of 2.06% in mid-March.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US Municipals	(0.43)	0.29	0.96	5.29

US municipals outperformed US Treasurys in the quarter with a small gain of just 0.3%. The market continued to experience strong inflows to municipal mutual funds relative to net supply.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US Securitized				
MBS: Mortgage-Backed	0.12	(0.05)	(0.25)	1.97
ABS: Asset-Backed	(0.01)	0.05	0.26	2.85
CMBS: Commercial Mortgages	0.29	0.13	1.35	5.25

Agency-backed mortgage securities have benefited for several quarters from the Federal Reserve's purchase program. However, as the market perceived we may be getting closer to the end of that program, investors began debating whether the Fed will eventually sell its MBS holdings or just let the portfolio run off. MBS performance lagged during the quarter, though CMBS eked out a small gain as the grab for yield and improving commercial real estate fundamentals continued to draw in buyers.

[1] *All returns sourced from Barclays Indices except: World Government Bond (Citigroup), Emerging Market Bond (JPMorganChase), and S&P500 (FactSet and Ned Davis Research).*

RETURNS BY SECTOR[1] *as of March 31, 2013*

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Corporates				
US Investment Grade	0.02	(0.11)	0.95	7.47
AAA	(0.01)	(0.76)	(1.46)	3.98
AA	0.05	(0.20)	(0.05)	4.60
A	(0.14)	(0.34)	0.39	7.01
BBB	0.20	0.19	1.85	8.66
European Investment Grade *(local currency returns)*	0.52	0.56	3.59	8.06
AAA	0.71	0.66	2.99	7.62
AA	0.55	0.29	2.03	6.60
A	0.43	0.49	2.93	6.99
BBB	0.61	0.72	4.89	9.53
Sterling Investment Grade	1.73	1.76	4.32	13.14
AAA	2.34	0.74	0.43	8.89
AA	1.79	1.24	2.32	10.31
A	1.86	1.45	3.16	11.72
BBB	1.54	2.33	6.50	15.78

Spreads were relatively range-bound during the quarter across the US investment grade corporate market, generating a return slightly better than Treasurys. Lower quality (BBB-rated) bonds performed the best. Intermediate maturity bonds gained 0.4% while long bonds lost 1.9% as investors shied away from corners of the market most vulnerable to rising rates. Financials continued their dominance with gains of 0.9% for the quarter compared to losses of 0.7% for industrials. Insurance and brokerage bonds had some of the largest gains, while telecommunications, metals and energy saw some of the largest losses. Despite the political turmoil, European corporates outperformed their US counterparts, while sterling-backed bonds gained the most. In the sterling market, yields declined by 15 bps or more and spreads narrowed, in contrast to the more stable yields and spreads in the US market.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Corporates				
US High Yield	1.02	2.89	6.28	13.13
BB	0.72	1.96	4.82	11.92
B	1.00	2.73	6.43	13.10
CCC	1.85	5.79	9.30	15.76
Pan-Euro High Yield *(local currency returns)*	1.03	1.24	7.57	15.67
BB	1.03	1.28	7.13	14.55
B	0.95	1.29	8.40	17.37
CCC	1.31	0.89	8.95	23.27

With a gain of 2.9%, the US high yield market was one of the best-performing sectors in the fixed income universe. Despite investor caution regarding tight valuations on high yield offerings, demand remained strong. Many issuers have taken advantage of low yields and refinanced higher-cost debt. This has helped contain default concerns, particularly as the tone of economic data improved. Every industry in the index earned positive returns, with insurance and brokerage topping the list and cable and telecommunications at the bottom. Returns in the *Pan-Euro High Yield Index* were more diverse. The largest sectors of the market gained less than 1.0%, including banking (22% of the market), automotive (13%) and cable (7%). There was a wide dispersion of returns across the smaller sectors, including gains of 7.2% by insurance and nearly 5.8% by consumer cyclical services, but losses of 5.2% for media companies and 2.5% for non-electric/non-gas utilities.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Bank Loans				
US High Yield	0.81	2.21	3.67	15.67
BB	0.55	1.38	2.81	14.55
B	0.76	2.39	3.38	17.37
CCC	2.59	5.14	7.36	23.27

Yet again, high yield bank loans generated an attractive return, albeit one lower than the performance of high yield bonds. Investors were drawn to the relative safety of loans, given their senior position in the capital structure, yet ample yield relative to other sectors. New issuance surged as issuers refinanced into lower-rate debt, but the supply was easily absorbed by record inflows into bank loan mutual funds and ETFs.

RETURNS BY SECTOR[1] *as of March 31, 2013*

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Developed Countries				
World Government Bond Index (WGBI) *(local currency returns)*	0.74	0.86	1.65	4.85
Non-USD WGBI	1.00	1.30	2.41	5.69
United States	0.10	(0.18)	(0.25)	2.81
Canada	0.36	0.22	0.21	3.02
European GBI	0.67	0.38	2.80	7.85
France	0.81	(0.16)	1.88	7.84
Germany	0.99	0.39	1.50	4.73
Ireland	(0.14)	4.10	8.45	21.70
Italy	0.46	0.07	5.28	9.69
Portugal	0.01	3.30	13.70	44.48
Spain	0.16	2.74	8.48	8.20
United Kingdom	1.80	0.72	0.31	5.30
Japan	1.31	2.54	2.43	4.14
Australia	(0.22)	(0.11)	(0.78)	6.04

The US market lost 0.2% on a modest rise in longer yields for the worst performance in the developed markets space. Growth disappointments in Germany and the UK led to lower yields in the quarter and slightly better performance than the US, though the greatest returns were earned by Spain, Portugal, Ireland and Japan. A corruption scandal in Spain pushed yields up early in the quarter, though an easing of bailout concerns and successful debt auctions helped lower yields by quarter-end. Investors moved back into Irish debt as the country's prospects brightened, and they bought up Japanese government bonds to front-run the expected announcement of a BoJ purchase program. Italian returns were one of the worst in the sector primarily due to the difficult political situation. February's elections resulted in a hung parliament, sparking fear that needed reforms may be hard to implement.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Emerging Market Bonds				
Emerging Market Government (EMBIG) *(Sovereign/Quasi-Sovereign, USD)*	(0.75)	(2.30)	0.95	10.44
Corporate Emerging Market Bond (CEMBI) *(Corporates, USD)*	0.05	0.93	3.40	10.57
Emerging Market Government (GBI-EM) *(Governments, local currency)*	0.23	1.17	5.02	11.95

EMBIG returns disappointed as investors favored higher-yielding corporate and local currency sectors. Spreads on EM corporate debt offered generous yield pickups over US corporate offerings. Heavy supply was readily absorbed and both investment grade and high yield portions of the *CEMBI* outperformed US markets. By industry, the best performers were transportation and consumers, and the worst were energy and TMT (technology, media and telecommunications). Within the *GBI-EM* local currency space, Asia lagged and Latin America outperformed on the back of Mexico's strong performance. Mexico's close ties to the US (especially in manufacturing) and expected reforms have made it an investor favorite of late.

RETURNS BY SECTOR[1] *as of March 31, 2013*

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Currency Markets[2]				
Dollar Bloc				
Canadian Dollar	1.31	(2.49)	(3.31)	(2.06)
Australian Dollar	2.00	0.23	0.40	0.35
New Zealand Dollar	1.52	1.01	0.86	2.43
Western Europe				
Euro	(1.82)	(2.83)	(0.31)	0.03
Norwegian Krone	(1.87)	(4.83)	(2.09)	(1.76)
Swedish Krona	(0.95)	(0.38)	0.57	2.09
Swiss Franc	(1.32)	(3.56)	(0.99)	(4.52)
British Pound	0.23	(6.50)	(5.99)	(4.76)
Emerging Europe & Africa				
Czech Koruna	(2.10)	(5.30)	(2.64)	(7.36)
Hungarian Forint	(4.61)	(6.93)	(6.50)	(6.54)
Polish Zloty	(2.48)	(5.10)	(1.80)	(4.13)
Russian Ruble	(1.46)	(1.71)	0.40	(5.01)
South African Rand	(2.29)	(8.26)	(9.98)	(16.42)
Turkish New Lira	(0.65)	(1.47)	(0.73)	(1.40)
Asia				
Japanese Yen	(1.76)	(7.93)	(17.26)	(12.48)
Chinese Renminbi	0.19	0.33	1.20	1.55
Indonesian Rupiah	(0.68)	0.60	(1.48)	(5.67)
Malaysian Ringgit	(0.11)	(1.16)	(1.12)	(0.82)
Philippine Peso	(0.37)	0.48	2.28	5.32
Singapore Dollar	(0.15)	(1.49)	(1.04)	1.49
South Korean Won	(2.56)	(4.22)	0.00	2.30
Latin America				
Argentine Peso	(1.48)	(4.02)	(8.29)	(14.56)
Brazilian Real	(2.14)	1.47	0.23	(9.91)
Chilean Peso	0.19	1.49	0.54	3.74
Colombian Peso	(0.65)	(3.18)	(1.34)	(1.81)
Mexican Peso	3.63	4.23	4.28	3.82
Peruvian New Sol	(0.05)	(1.49)	0.29	3.06

The US dollar rallied this past quarter as the US growth outlook seemed brighter (or less dim?) than many other countries. Also, investor complacency over Europe was shattered in the wake of inconclusive Italian elections, a corruption scandal in Spain, and a funding crisis in Cyprus. Most currencies underperformed the dollar, with notable exceptions in Latin America. Canada's economy appeared softer than expected, making the need for rate hikes less urgent and leading to a loss of 2.5%. Growth in the euro zone remains challenged and the political events further shook investor confidence, resulting in a decline of 2.8% for the euro. The British pound fell by 6.5%, primarily on fears of recession and a more dovish central bank. Eastern European currencies fared even worse than their Western European counterparts. The Japanese yen fell sharply on plans by the government to end deflation via aggressive fiscal and monetary policy. Other than the US dollar, the quarter's best performers were the Mexican and Chilean pesos and the Brazilian real. Mexico offers an attractive interest rate differential to investors and a growth story, while Brazil's currency is currently being used actively as a policy tool to fight inflation.

[1] *All returns sourced from Barclays Indices except: World Government Bond (Citigroup), Emerging Market Bond (JPMorganChase), and S&P500 (FactSet and Ned Davis Research).*
[2] *Currency returns are relative to the US dollar.*

Past performance is no guarantee of future results.

All indexes are unmanaged, do not incur fees, and you cannot invest directly in an index.

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INDEX DEFINITIONS

Barclays US Aggregate Bond Index *is a broad-based benchmark that measures the investment grade, US-dollar-denominated, fixed-rate taxable bond market including Treasurys, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS.*

Barclays US Government/Credit Index *includes Treasurys (i.e., public obligations of the US Treasury that have remaining maturities of more than one year), government-related issues (i.e., agency, sovereign, supranational, and local authority debt), and corporates.*

Barclays US Treasury Index *includes public obligations of the US Treasury with at least one year until final maturity, excluding certain special issues such as state and local government series bonds (SLGs), US Treasury TIPS and STRIPS.*

Barclays US Agency Index *includes agency securities that are publicly issued by US government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the US government (such as USAID securities).*

Barclays US Municipal Index *covers the US-dollar-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prerefunded bonds.*

Barclays US Securitized Index *consists of the US MBS Index, the Erisa-eligible CMBS Index, and the fixed-rate ABS Index. The US Mortgage-Backed Securities (MBS) Index covers agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The US CMBS Investment Grade Index measures the market of conduit and fusion CMBS deals with a minimum current deal size of $300mn. The fixed-rate ABS Index includes securities backed by assets including credit and charge card, auto loan, home equity loan and stranded-cost utility.*

Barclays US Corporate Index *is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market. It includes US-dollar-denominated securities publicly issued by US and non-US industrial, utility, and financial issuers that meet specified maturity, liquidity, and quality requirements.*

Barclays Euro Corporate Index *tracks the fixed-rate, investment-grade euro-denominated corporate bond market. Inclusion is based on the currency of the issue, not the domicile of the issuer. The index includes publicly issued securities from industrial, utility, and financial companies that meet specified maturity, liquidity and quality requirements.*

Barclays Sterling Aggregate Corporate Index *is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate sterling-denominated bond market. Inclusion is based on the currency of the issue, not the domicile of the issuer. The Index includes publically issued securities from industrial, utility, and financial companies that meet specified maturity, liquidity and quality requirements.*

Barclays US Corporate High-Yield Index *measures the market of US-dollar-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt.*

Barclays Pan-European High-Yield Index *measures the market of non-investment grade, fixed-rate corporate bonds denominated in the following currencies: euro, Pounds sterling, Norwegian krone, Swedish krona, and Swiss franc. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. Inclusion is based on the currency of issue, and not the domicile of the issuer.*

Barclays US High Yield Loan Index *tracks the market for dollar-denominated floating-rate leveraged loans. Instead of individual securities, the US High Yield Loan Index is composed of loan tranches that may contain multiple contracts at the borrower level.*

Standard & Poor's 500 (S&P 500®) Index *is a market capitalization-weighted Index of 500 common stocks chosen for market size, liquidity, and industry group representation to measure broad US equity performance.*

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Citigroup World Government Bond Index (WGBI) *measures the market for the US and most developed nation government bond markets. The index is market capitalization weighted and has a minimum credit quality of A-/A3 by either S&P or Moody's and a minimum maturity of one year. Included is fixed-rate sovereign debt denominated in the domestic currency.*

JPMorgan Emerging Markets Bond Index Global (EMBIG) *measures the market for US-dollar-denominated Brady bonds, Eurobonds, and traded loans issued by sovereign and quasi-sovereign entities of qualifying emerging market countries.*

JPMorgan Corporate Emerging Markets Bond Index (CEMBI) *is a market capitalization weighted index consisting of US-dollar-denominated emerging market corporate bonds.*

JPMorgan Government Bond Index-Emerging Markets (GBI-EM) *tracks local currency bonds issued by emerging market governments.*