Fixed Income Market Commentary

July 2012

Mid-Year Review

Global concerns eased somewhat in June after a resurgence of worries over the euro-zone debt crisis gripped markets earlier in the quarter. As a result, risk appetites made a brief return. Not surprisingly, with strong equity market performance there was a bit of weakness in the Treasury market, though bond yields remain near their historic lows.

While confusion reigns overseas, at home the Federal Reserve continues to acknowledge that risks of greater economic slowing remain and is acting to address them, announcing an extension of what is referred to as "Operation Twist" (selling short-maturity government securities and replacing them with longer ones). I believe there will be further Fed intervention as the year progresses. If not, then that will most likely be an acknowledgement that the Fed is trying to keep a lid on rising interest rates.

Six Months In

Through the first half of the year, the **Treasury** index posted a return of 1.5%. On its face, that doesn't seem to amount to much, but when you begin the year with the benchmark 10-year bond yielding just 1.87%, earning the equivalent of almost the full yield in half a year is pretty good. Of course, with Treasury yields hovering around 1.60%, the prospect of much greater returns in the Treasury market is reduced.

Fearful investors, including large institutions, kept Treasury demand and prices high during the first half of the year. Their apprehension stems from a variety of sources. Whether it is worries over the euro zone or our own economic data, the "fear trade" seems to be propping up the Treasury market. It certainly isn't because investors piling into Treasurys are hoping for a quick profit—not at sub-2% yields anyway. In an odd twist, all of the institutional money flowing into Treasurys has left them more prone to a price reversal if or when that money flows the other way, making Treasurys more risky as a result.

Inflation-linked Treasurys performed quite well by comparison. The TIPS index returned just over 4% even though there appears to be no major threat of inflation. TIPS sold off a bit in June, perhaps in response to comments from Fed Chairman Bernanke that inflation is not one of his major concerns right now. I am not looking for the Fed to make any changes to their current policy assessment. If inflation remains low, then low interest rates and plentiful liquidity are here to stay.

While the "fear trade" is operative in the Treasury market, in the credit markets lower-rated "Caa" bonds in the **high yield** index easily outperformed their higher-quality counterparts. Ample investor appetite in an otherwise yield-deprived environment is pushing up prices in the low-quality segment of this market. This may be short-sighted. If the economy weakens further, this portion of the high-yield sector is poised to disappoint. I remain convinced that higher-quality high-yield is the safer and steadier asset to own.

High-yield default rates remains below 2%. Still, year-to-date, 17 companies have defaulted on their high-yield debt including Residential Capital Corp (Res Cap—the GMAC mortgage company), Houghton-Mifflin (publishing) and Hawker Beechcraft (airplanes). While some analysts believe default rates are headed higher, I think it can stay within this range. Companies issuing high-yield debt usually do better in a thriving economy. Yet, those that have already survived the much tougher period of a few years ago are battle-hardened and should be able to manage the current economic conditions. Some are also now able to refinance at much lower rates, which helps lower their interest expenses.

Barclays Fixed Income Index Total Returns Through 6/30/12

	Duration	June	YTD '12	Return '11	Return '10	Return '09
US T-Bill Index	0.33	0.01%	0.04%	0.15%	0.22%	0.37%
US Treasury Index	5.71	-0.35	1.51	9.81	5.87	-3.57
US TIPS Index	5.04	-0.56	4.04	13.56	6.31	11.41
US Aggregate Bond Index	5.07	0.04	2.37	7.84	6.54	5.93
US Govt / Credit Index	5.99	-0.02	2.65	8.74	6.59	4.52
US Credit Index {A2}	6.89	0.43	4.55	8.35	8.47	16.04
US High Yield Index {B1}	4.06	2.11	7.27	4.98	15.12	58.21
Caa component	3.58	2.40	9.28	1.18	16.43	90.65
Emerging Market ($$) {BA1}	6.63	2.75	6.95	6.97	12.84	34.23
Municipal Index	7.50	-0.11	3.66	10.70	2.38	12.91
Municipal Index - 5 Year	3.90	-0.02	1.80	6.93	3.40	7.40

Source: Barclays Capital

Municipal bond performance remained strong, as this asset class continues to be very popular with individual investors. The primary muni index returned 3.7% in the first half in spite of a slew of negative headlines and some high-profile defaults.

Recent defaults by Stockton and Mammoth Lakes, both cities in California, are unique in my opinion, and do not reflect conditions in much of the rest of the country. The unusual circumstances in these cities include accounting irregularities, overly generous benefits and, in the case of Mammoth Lakes, a lawsuit which the municipality came up on the losing side of the judgment.

As I write this, another California municipality is on the cusp of bankruptcy—the City of San Bernardino. Details are still sketchy, but it appears that the factors leading up to this filing are similar to those I just mentioned.

While I acknowledge the severity of state and local budget problems across the country, I still firmly believe that municipal bankruptcies will remain rare and that most municipal officials will do everything in their broad powers to avoid them.

As the third quarter opens, there is still concern about the pace of economic expansion. Until we see signs of stronger growth, I expect bonds to remain in significant demand even if their absolute yields are low. As for the bankruptcy news at the municipal level, it will make headlines, but don't be misled into believing that a tidal wave of bankruptcy is about to hit. In the scheme of things, this $3.5 trillion market remains solid and bankruptcies will continue to be a rare occurrence overall.

Christopher Keith
Senior Vice President
Fixed Income Manager