Fixed Income Market Commentary

December 2011

Occupy the World

Agree with them or not, the "Occupy" crowd has garnered a lot of attention.

To many, including me, some of their positions seem inconsistent with reality and their own behavior. But that doesn't mean they don't have some valid points to make, or that I am oblivious and insensitive to the predicament that many Americans face. These are challenging times, indeed.

Treading on more familiar terrain, the bond market is experiencing its own sort of Occupy movement. Large, institutional investors have staged a protest (boycott) of almost anything that smells of risk. You may have seen the terms, "risk-on" and "risk-off" used to explain what's happening in many investment markets.

In the bond market, risk-on/risk-off refers to trading that, en masse, pushes Treasury prices higher (risk-off) or lower (risk-on). Lately, whenever the news flashes more troubles in Europe, investors take risk off the table and flee to the safety of Treasurys. The flight to quality comes in the face of legitimate fears of a major sovereign default. When the news brightens, investors are willing to put risk back on, and Treasury prices decline.

In essence, the sovereign bond market has occupied the world's financial markets and it's become a guessing game as to which European nation will be the first to default.

Like the police that finally reclaimed parks and plazas from the Occupy crowds, the Federal Reserve stepped in at the end of November. Along with central banks of Switzerland, Canada, England, Japan and the euro zone, the Fed agreed to lower interest rates in the global currency markets used by large banks to maintain liquidity. The news spurred stock markets around the globe to gains of 4% or better for the day.

Markets are supposed move higher on good news. Yet, while the immediate implications of the central banks' intervention was positive, the inconsistency is that the action was taken because European banks' problems were growing clearer, or bigger. To me, this is simply financial engineering to provide a quick fix. The intervention did very little to change the structural problems that got banks into this mess in the first place.

Sovereign bond yields tell the tale. Yields on Greek debt have been climbing for months. Now the contagion is spreading; most recently to Italy. The year began with Italy's 10-year sovereign bonds yielding 4.4%. Yet, while rates have fallen in the U.S., Italian yields soared as high as 7.4% in early November. They ended the month at 7.0%, sending Italy's borrowing costs skyrocketing at a time that it has hundreds of billions of dollars of debt coming due in the near future. Much of this will need to be refinanced with new bonds. It almost certainly will get worse before it gets better.

While recent news suggests most of the euro nations are finally climbing on board efforts at reform, including clearer and closer oversight, the ECB has said it will not serve as the rescuer of last resort. While we may see further clarity in the days to come, it will be months and years before we know the ultimate outcome of today's deliberations. We may be "occupied" with Europe for longer than we originally thought.

That said, the individual bond portfolios that we manage at Adviser Investments focus on the domestic, investment-grade and municipal bond universe and should be relatively immune to the Euro-mess. We typically do not hold Treasury debt obligations because our mandate allows us to search for higher-yielding opportunities elsewhere. When we do that, we stick with bonds issued by high-quality companies. While today's yields may not be exciting, we believe our disciplined strategy for capital preservation, income production and thoughtful portfolio structure should safely occupy your world for years to come.

Market Review

Investors continued to favor the highest-quality bonds in November. Treasury and Inflation-linked Treasury markets continued to be the winners, up 0.75% and 0.77%, respectively. The problems in Europe and possible repercussions of a sovereign default kept Treasurys in demand.

The Municipal Bond market turned in a solid performance, too, despite a long-expected default that finally saw its curtain drop during the month. The Jefferson County Alabama Sewer Authority defaulted on more than $3 billion in debt, and the market didn't even blink, since it took nobody by surprise. The municipal index returned 0.59% in November. Even though munis turned in good numbers, their performance lagged that of the Treasury market. As a result, they remain very cheap in relative terms.

Lastly, it was "risk-off" in credit markets. Investment-grade corporate bonds, speculative-grade (high-yield) corporate bonds and emerging market debt all finished with losses for the month. Lower-quality, high-yield bonds fell 3.6% while higher-rated, high-yield bonds lost 2.1%. Emerging market debt dropped 1.2%. With one month still to go, most bond investors have fared quite nicely this year.

Barclays Fixed Income Index Returns Through 11/30/11

	Duration	Nov	YTD '11	Return '10	Return '09	Return '08
US T-Bill Index	0.33	0.01%	0.14%	0.22%	0.37%	2.44%
US Treasury Index	5.90	0.75	8.76	5.87	-3.57	13.74
US TIPS Index	5.17	0.77	13.52	6.31	11.41	-2.35
US Aggregate Bond Index	5.02	-0.09	6.67	6.54	5.93	5.24
US Govt / Credit Index	5.95	-0.23	7.35	6.59	4.52	5.70
US Credit Index {A2}	6.66	-1.68	6.29	8.47	16.04	-3.08
US High Yield Index {B1}	4.36	-2.16	2.26	15.12	58.21	-26.16
Caa component	3.90	-3.58	-2.06	16.43	90.65	-44.24
Emerging Market ($$) {BA1}	6.38	-1.26	5.46	12.84	34.23	-14.75
Municipal Index	8.23	0.59	8.63	2.38	12.91	-2.47
Municipal Index - 5 Year	3.91	0.79	5.53	3.40	7.40	5.78

Source: Barclays Capital

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