Outlook on **US Fixed Income**

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The second quarter of 2013 seems to have awakened many fixed income investors to the return risks that are inherent in an excessively low interest rate environment. We have long held that the low yields of safe-haven fixed income investments are unsustainable and that there is little upside potential left in fixed income investments from further declines in interest rates. Given the underlying economic conditions, we believe that the fair value yield for the risk-free US 10-year Treasury is closer to 3.0%–3.5% than to 2.0%. We reiterate our position that credit spreads in many areas of the US market continue to be insufficient to protect fixed income investors from a rise in rates.

Interest rates were quite volatile during the second quarter of 2013. The US 10-year Treasury yield fell from 1.82% (around the middle of its recent trading range) to 1.65% in the thick of the Cypriot banking crisis. Rates backed up toward the 1.90% level and then began to rise sharply following US Federal Reserve (the Fed) Chairman Ben Bernanke's May 22 testimony. With this move in late May, rates seem to have broken through the prior range. The anticipation of the Fed tapering its quantitative easing programs has likely established a new plateau for yields, as they continue to move up toward levels consistent with underlying economic activity. Given the current conditions, we believe investors should revisit the risk and reward trade-offs for fixed income asset classes, and be wary of the risks associated with rising interest rates and associated spread widening for the balance of the year.

Our base-case scenario remains unchanged: A healthier economy will help interest rates continue to grind higher and we will continue to experience periods of higher volatility. Interest rate volatility has been historically low over the last year and, as yields rise, we expect volatility to increase to prior levels. In addition, we believe that a deteriorating macroeconomic environment, characterized by recession or deflation fears, is unlikely to support a move to dramatically lower rates than those already experienced.

Interest Rate and Liquidity Risks

The question we receive the most from clients is: How do you diversify against rising US interest rates? Conventional wisdom has been that diversifying exposures by shifting to non-US markets, especially emerging markets, offers a level of protection against rising US interest rates. However, we believe that many of these markets are currently correlated to US interest rates due to similar monetary policy regimes, economic interdependencies, or other factors such as market liquidity. In today's marketplace, we believe one of the best ways to diversify US interest rate risk is through mispriced credit opportunities within the US market. This approach has been proven to add value relative to interest rates, with the added benefit of lower volatility than non-US investments.

The second most-asked question we receive from clients is: What happens if investors decide to divest their historically large fixed income allocations in a rising interest rate environment? This question is difficult to answer. We believe that the fixed income market is prone to illiquidity dislocations due to the fragility of the current market-making environment. Most of the securities in the fixed income marketplace trade on an over-the-counter basis. As a result of regulation and deleveraging, the amount of capital available to absorb supply/demand imbalances from either broker/dealers or proprietary hedge funds has declined substantially. This lack of market-making capacity means that there may be a lack of readily available buyers or sponsors if investors seek to exit their fixed income allocations in large numbers. Such dislocations of supply and demand lead to unforeseen pricing gaps and increased volatility of outcomes. This market-making paradigm is of particular concern to two types of investors: those that are long the asset categories that have been overvalued as a result of the prior flight to safe-haven assets, and those that are long high-yielding asset classes that have historically been thinly traded, but recently supported by flows from non-strategic buyers seeking income.

During the sell-off in May, we saw hints of how these supply/demand imbalances can affect markets in unforeseen ways when CCC-rated US high yield securities outperformed BB-rated securities, or when emerging-market corporates outperformed sovereigns. While the outperformance of riskier assets in down markets may seem counterintuitive, it fits the pattern of non-strategic buyers shedding assets in greater numbers than strategic buyers. It is important to note that through May, bid-offer spreads remained reasonable and trading remained orderly, as there were buyers for the paper being offered by sellers. However, that may not necessarily be the case in the future. Investors need to take stock of what they own, and how those securities may trade in this low-capital environment relative to their liquidity needs. We believe that liquidity will continue to be an important consideration, particularly in the short-duration space, where higher-yielding assets that have historically demonstrated thin sponsorship have received strong support from non-traditional buyers in the low interest rate environment.

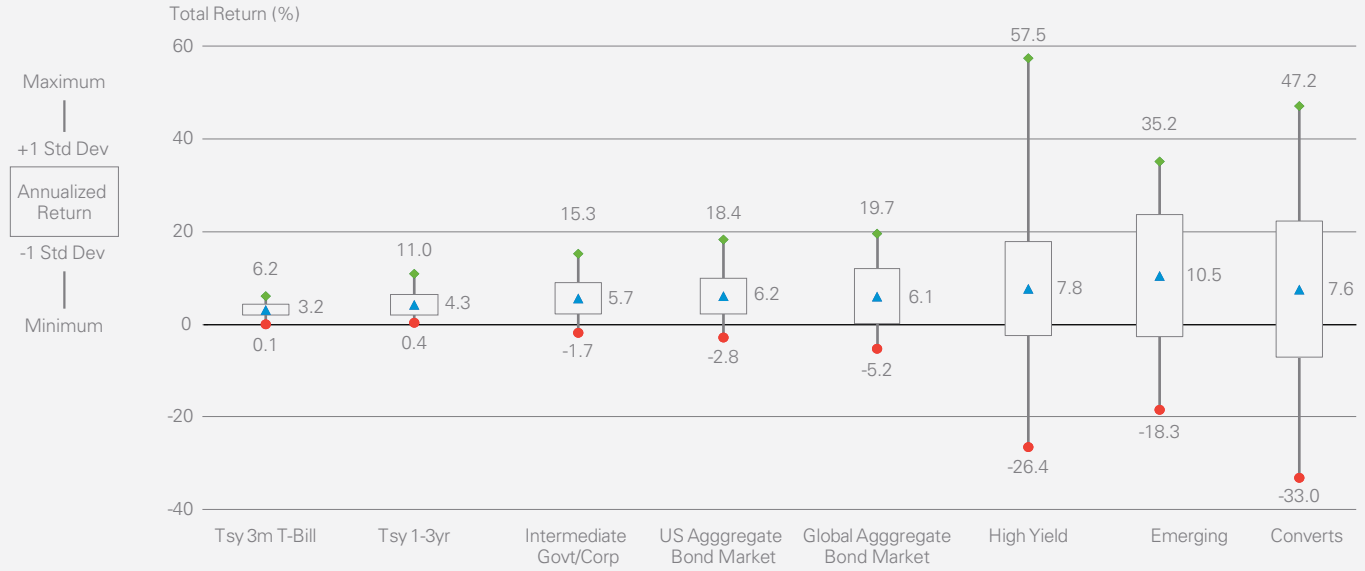
Why Own High-Quality Fixed Income?

Given all of the current risks in fixed income markets, an investor might wonder: Why own fixed income at all? In our view, high-quality fixed income securities–which we define as securities with US-centric credit risk that have a timely and predictable return of principal and income–exhibit characteristics that are attractive from an asset allocation perspective. Properly identified high-quality fixed income securities diversify risk assets and have a known terminal value. Unlike other diversifying assets that require a market price to realize value, the cash flow of a money good fixed income investment is defined and, if held to redemption, the investor knows exactly what they will earn. In prior periods of distress (including the 2008 financial crisis), properly identified high-quality US fixed income securities have reliably maintained their liquidity and have had strong positive total returns relative to other asset classes. Further, if the rise in US interest rates is unexpectedly volatile or large in magnitude, we believe it is likely that many other asset classes will suffer greater mark-to-market losses than properly identified high-quality fixed income assets.

However, it is important to consider that not all highly rated US dollar-denominated securities meet the definition described above. This is a factor often not considered by investors seeking higher returns from assets that exhibit higher yield spreads. Investors often overlook the fact that higher yield spreads represent excess compensation for the assumption of higher risks.

Even within the definition of high-quality assets, an investor will often reach for excess returns without considering the potential consequences of the decision. As Exhibit 1 below demonstrates, it is important that, particularly during this period of repressed yields, investors focus on their tolerance for risk. It is up to each investor to determine how much risk, what type of risk, and what level of loss they will be willing to bear when choosing the appropriate fixed income exposures. More yield often equates to lower returns.

Exhibit 1
Higher Yields Often Equate to Higher Volatility



As of December 31, 2012.
Data from December 31, 1994 through December 31, 2012
The performance quoted represents past performance. Past performance is not a reliable indicator of future results.
This information is for illustrative and comparative purposes only.
Source: Lazard, Bank of America Merrill Lynch

We suggest that investors allocate assets based on objectives. We believe that the objective of fixed income exposures in the current environment should be capital preservation, and that investors should be wary of reaching for excess returns within the fixed income asset class. As interest rates normalize in the current environment, fixed income return outcomes are likely to be volatile, and the downside potential for riskier/higher-yielding fixed income securities is likely to be very high. For investors seeking outsized returns, we suggest allocations to equity markets, where they have the potential to be better compensated for the fundamental investment risks assumed, and where market-clearing liquidity risks are better mitigated.

Opportunities

We believe that there are attractive opportunities in the credit markets for investors who can identify individual securities that are mispriced. Much of the mispricing in today's market comes from two basic factors: prepayment volatility risk and headline risk. Therefore, we have found value in specific pools of agency mortgage-backed securities (MBS), whereby we have identified particular payment characteristics that we find attractive; taxable municipals, where market dislocations due to headlines can create opportunity; corporates that have been the focus of negative news, which has led to increased equity volatility, but that have remained sound credits from a lending perspective; and corporate BB/B-rated non-distressed high-yield securities, which we believe offer a superior source of diversifying excess income.

Careful security selection in fixed income markets is imperative. A strong understanding of the investment risks—from terms and conditions, sponsorship, and the willingness and ability to repay principal and interest—is key to avoiding impairment. Many investors shun seemingly troublesome sectors or industries, but by "peeling back the onion" and conducting fundamental analysis, one can often find sound opportunities in those areas that are currently subject to volatility from news flow.

For example, despite the negative headline rhetoric, the US corporate high-yield space remains the best-performing "plus" category in the fixed income market. The US high-yield segment includes recently recapitalized US mid-cap companies that are able to operate more efficiently in a low-growth environment. Improved operating protection, stronger balance sheets, and low default rates combine to lend fundamental support to this higher-yielding asset class. However, as discussed previously, careful security selection is imperative in this space given the potential for future liquidity challenges.

Conclusion

We expect interest rates to progressively normalize to more sustainable levels within the context of a growing macroeconomic environment. Under these conditions, we believe the probability investors assign to a recession should wane, leading to higher and more sustainable equity returns. However, as illustrated by previous periods of market stress, if the Fed's pause causes recession fears to resurface, an allocation to properly identified high-quality US fixed income will be key to providing downside protection against declines in other asset classes.