

Fixed Income Market Review

In Brief

- ▶ Fixed income markets remained resilient during the first quarter, as spread sectors maintained strong returns.
- ▶ Central banks are becoming more concerned about inflation, with most non-US policy makers instituting monetary tightening.
- ▶ European sovereign credit concerns dominated headlines as peripheral countries' credit continues to be downgraded, and a mechanism to repair the current situation has yet to materialize.

Executive Summary

Despite military intervention by NATO in Libya, a devastating earthquake in Japan, and on-going fiscal imbalances in peripheral Europe, the fixed income markets were surprisingly resilient during the first quarter of 2011. Higher yielding, higher beta sectors maintained their strong run in the US, with duration-adjusted excess returns for the US Barclays Capital High Yield Index and the US Barclays Capital CMBS Index reaching 3.87% and 2.03% during the quarter, respectively.

Popular uprisings across the Middle East and North Africa, combined with global economic strength, brought oil prices to over \$100 per barrel. Commodity prices, including staples such as food and cotton, significantly increased during the quarter as natural catastrophes, demand growth, demographic change, and excess global liquidity largely due to the US Federal Reserve's accommodative policies influenced supply/demand dynamics. Food and oil price pressures began to translate into inflation, particularly in emerging market economies where these factors make up a large portion of CPI baskets. To combat inflation, many non-US policy makers were forced to employ tightening measures, with the European Central Bank expected to hike rates at their next meeting.

Focus towards the end of the quarter was on Europe as sovereign credit concerns regarding the European peripheral countries remained and the results of the meeting of the European Council Heads of State on 25 March to finalize the details of the European Stability Mechanism (ESM) disappointed the market. During the quarter there were numerous peripheral country credit downgrades as ratings continue to converge to market perceptions, and continued even after the 25 March meeting as it highlighted the difficulties in reaching consensus. The current resistance to restructuring primarily stems from the vulnerability of the collective euro area banking system to peripheral sovereigns and is likely to remain until banks are sufficiently recapitalized. The agreed-upon package decided on during the meeting provides a framework to address medium- to long-term issues in the euro area and prevent a future crisis through the ESM, but it fails to effectively tackle the current crisis in the periphery. The reforms increase the available funding; however, instead of resolving the current solvency problem, they merely push the risk of default out to mid-2013. In fact, since the 25 March meeting, five-year CDS in Greece, Ireland, Portugal, and Spain all rose between 8 and 27 basis points as of quarter end. We expect further downwards rating migration in the near-term as agencies continue to digest the credit implications of the ESM.

Index Returns

(Returns in USD, as of 31 March 2011)

Fixed Income Indices	1Q11 (%)	1-Year (%)
BarCap Aggregate	0.42	5.12
BarCap Global Agg—Hedged USD	-0.20	2.66
BarCap Universal	0.68	5.73
BarCap Treasury	-0.16	4.53
BofA Merrill Lynch 1-3 Year Treasury	0.03	1.67
BarCap U.S. TIPS	2.08	7.91
BarCap Mortgage	0.58	4.37
BarCap U.S. Credit	0.89	7.01
BarCap U.S. Corporate IG	0.86	7.46
BarCap Intermediate Govt/Credit	0.34	4.63
BarCap Long Govt/Credit	-0.02	8.45
BarCap Municipal	0.51	1.63
BarCap High Yield	3.88	14.31
BarCap High Yield—2% Issuer Cap	3.89	14.26
Citigroup World Govt Bond—Hedged USD	-0.70	1.52
Citigroup World Govt Bond—Unhedged	0.66	7.29
JPMorgan EMBI Global	1.02	8.65

Equity Indices	1Q11 (%)	1-Year (%)
Dow Jones Industrial Average	7.07	16.51
S&P 500	5.92	15.65
Nasdaq Composite	5.09	17.18

Source: Bloomberg, Barclays Capital, Citigroup, JPMorgan, FactSet

Executive Summary (continued)

Despite these external geopolitical concerns, US economic data remains largely positive. However, there are still reasons to be cautious about the employment recovery as the downward trend in unemployment is only gradually improving, and fiscal pressures at the state and local level are leading to a reduction in government payrolls. The Treasury announced its intention to sell its remaining \$136 billion par value of agency mortgage-backed securities (MBS). It plans to sell up to \$10 billion of agency MBS per month, subject to market conditions.

In addition, it estimates that the existing mortgage portfolio will pay down at the rate of \$3 to \$5 billion per month. Thus, barring unforeseen market conditions, the entire portfolio should be liquidated within 12 months. The statement released by the Federal Open Market Committee after its 15 March 2011 meeting expressed a more hawkish tone in regards to monetary policy, leaving investors to wonder if the Fed will hike interest rates earlier than expected, start selling its own MBS portfolio, or both.

Figure 1: Fixed income duration-adjusted excess returns vs. Treasuries (%)

Fixed Income Indices	1Q11	1-Year
U.S. Aggregate	0.50	1.41
Aaa	0.29	1.07
Aa	0.72	1.47
A	1.18	2.47
Baa	1.60	3.42
Agencies	0.28	0.73
ABS	0.61	0.95
CMBS	2.03	8.41
MBS	0.55	2.09
Investment Grade Credit	1.05	1.83
Corporate	1.02	2.15
- Industrials	0.74	1.67
- Utility	0.86	1.72
- Finance	1.48	2.99
Non-Corporate	1.15	0.58
High Yield	3.87	10.08
High Yield—2% Cap	3.88	10.01
- Ba	3.44	8.60
- B	3.69	10.09
-CCC	4.85	11.82
Emerging Markets	1.98	3.58

Source: Barclays Capital; Note: Based on Barclays U.S. Aggregate, Barclays High Yield, and Barclays Global Emerging Markets indices; as of 31 March 2011

Index performance is shown for illustrative purposes only. It is not possible to invest directly in an index.

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Figure 2: Global yields (%)

	3-Month	2-Year	5-Year	10-Year	30-Year
U.S. Treasuries	0.09	0.82	2.28	3.47	4.51
U.S. Swaps	0.30	0.95	2.40	3.54	4.27
Canada	0.96	1.83	2.77	3.35	3.76
Germany	0.75	1.79	2.67	3.35	3.80
U.K.	0.63	1.36	2.44	3.69	4.36
Japan	0.20	0.21	0.50	1.26	2.19

Source: Bloomberg; as of 31 March 2011

Figure 3: Global yields—quarterly change (%)

	3-Month	2-Year	5-Year	10-Year	30-Year
U.S. Treasuries	-0.03	0.23	0.27	0.18	0.17
U.S. Swaps	0.00	0.15	0.22	0.15	0.15
Canada	-0.09	0.15	0.35	0.23	0.23
Germany	0.44	0.93	0.83	0.39	0.38
U.K.	0.06	0.26	0.25	0.29	0.17
Japan	0.00	0.03	0.09	0.13	0.19

Source: Bloomberg; as of 31 March 2011