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Fourth Quarter 2009 | *Interest Rate Trends* | Quarterly Newsletter

Interest Rate Trends

Steep yield curve! Is the bond market telling us something? Traditional thinking holds that a steep yield curve forecasts economic recovery. Many economic indicators lend support to that argument. The contrarian point of view holds that any economic recovery will be slow and that the steep curve is merely a reflection of increased supply and the bond investor's need to be paid more to accept longer term risk. Reasons aside, the yield curve has steepened to levels not seen since the previous recession in 2003. As of December 31, 2009, the yield differential between Treasury 2 years and 30 years was 350 basis points. Much of that steepening occurred in the 4th quarter as the long end of the curve rose 59 basis points versus the short end's 19 basis point increase.

Index Returns

	Qtr.	1 Yr.	3 Yr. Ann.
Barclays Aggregate	0.20%	5.93%	6.04%
Barclays Govt/Credit	-0.21%	4.52%	5.81%
Barclays Int. Govt/Credit	0.31%	5.24%	5.90%

Source: Barclays Capital — As of December 31, 2009

Treasury Market Yields	12/31/09	9/30/09
2 Year	1.14%	0.95%
5 Year	2.68%	2.31%
10 Year	3.84%	3.31%
30 Year	4.64%	4.05%
Commodities		
Oil ($ bal)	$79.36	$76.91
Gold ($/oz.)	$1,096.20	$1,027.60
CRB Index	283.38	259.39
Spread Product (Spread to 10 Yr. Treasury)		
10 Yr. "A" Corp	+1.61%	+1.89%
GNMA Current Coupon	+0.68%	+0.94%
10 Yr. "AA" Municipal	-0.65%	-0.58%

Economic Indicators

- Final 3Q **GDP** was recently reported at positive 2.2% annualized. With one quarterly exception (Q2 2008), GDP growth has been negative since the beginning of 2008.
- **Consumer Confidence** has also turned up recently. The Michigan survey rose from 67.4 to 72.5 and the Conference Board Survey increased from 50.6 to 52.9. The recent strength is attributed to improved consumer expectations, perhaps due to rising stock market prices and a small bounce back in the jobs picture.
- With regard to jobs, the last **Employment** report (November data) was a mild surprise to the upside. The Unemployment Rate fell to 10% from 10.2%. Meanwhile, Nonfarm Payrolls continued to show contraction at -11,000 jobs, but this at a slower pace than had been expected (-125,000).
- December **Personal Income and Spending** statistics also showed some bounce. Income was up 0.4% and Spending was up 0.5%. A graph of this series indicates that it too has turned upward off of the year ago lows.
- Not all economic numbers are turning positive. Recent **housing** statistics point to continued weakness. The S&P/Case Schiller Composite printed at -7.28% annualized at the end of December (October data). This measure of prices in 20 large U.S. real estate markets has been negative since the beginning of 2007.

Inflation and the Federal Reserve

The weak economy continues to exert a dampening influence on inflation. Although the CPI rose 0.4% in December as a result of increased gasoline prices, the Core CPI rose a tame 0.1%. Both CPI and Core CPI are annualized at 1.8%. The Core PCE Deflator also remains in "well contained" territory at 1.4%. As of December 16th, the Federal Reserve continues to state that "inflation will remain subdued for some time." However, their recent statement included the phrase: "financial market conditions have become more supportive of economic growth."

Conclusion

While positive economic data predominated in the month of December, the timing and strength of the U.S. recovery, signaled by the steep yield curve, are still big question marks. Our consumer-driven economy has been successfully supported by government stimulus, but eventually that stimulus will run out. Many economists argue for continued, even stronger, fiscal stimulus until balance sheets are repaired and employment rekindles. Meanwhile, the ugly U.S. deficit picture begs for a return to fiscal discipline. The politics could be messy.

Two Ways to Get to the Same Place

As market participants think about the fixed income markets of 2008 and 2009, they heave a sigh of relief at having survived the financial crisis that shook the whole investment world. But, **if one were to look only at the returns of the Barclays Capital Aggregate Index over the past two years** (the Aggregate Index in 2008 posted a 5.24% total return which was only slightly below the 2009 return of 5.93%), **one might not realize that we experienced a financial crisis.** But how the index actually posted these similar returns over the past two years is vastly different and underscores a major reversal of fortune in the different fixed income sectors (see box).

Fixed Income Index Returns	2008	2009
Barclays Capital Aggregate Index	*5.24%*	*5.93%*
Treasury Index	13.74%	-3.57%
Agency Mortgage-backed Securities Index	8.34%	5.89%
Agency Index	9.08%	1.95%
Corporate Index	-4.94%	18.68%
Asset-backed Securities Index	-12.72%	24.72%
Commercial Mortgage Securities Index	-20.52%	28.45%

Source: Barclays Capital

Treasuries were the strongest sector in 2008, with a 13.74% return. In 2008, market panic drove a Treasury "flight to quality" which propelled Treasury rates lower and returns higher. As the crisis abated, Treasury yields increased in 2009 and the sector returned -3.57%. Agency Mortgage-backed securities (MBS) were resilient in both 2008 and 2009 with returns of 8.34% and 5.89% respectively. With the U.S. Treasury implicitly backing the two GSE's, Fannie Mae and Freddie Mac, the MBS sector has seen spreads tighten to historically low levels. Agency debentures also fared well in 2008 and 2009, benefitting again from the U.S. Treasury support.

The two worst performing sectors in 2008, Asset-backed securities (ABS) and Commercial Mortgage-backed Securities (CMBS) posted the strongest returns in 2009. It is surprising how quickly investors' appetite for risk returned from the 2008 crisis. One side-related note to structured assets is that the "rising tide" of risk appetite did not apply to all fixed income securities. Some esoteric structured assets (subprime mortgages, CDO's and SIV's) created in 2006 and 2007 remain distressed.

The Corporate sector, which comprises 19% of the Aggregate Index at the end of 2009, is the main catalyst for the strong performance of the index this past year. In 2008, as spreads on all corporate bonds widened, the sector had a -4.94% return. The first three months of 2009 also saw spreads widen as the crisis intensified. However, the last three quarters of 2009 were remarkable as the corporate sector rebounded to return 18.68% for the year. **Because the ABS sector and the CMBS sector still represent small percents in the index, the corporate bond turnaround has been the main driver of positive returns in 2009 for the Barclays Aggregate Index.**

The spreads or additional yield an investor can receive by owning corporate bonds remains wider than historical averages. In particular, the hard hit financial sector has still not rebounded to pre-crisis levels and offers some attractive yields. Meanwhile, the Treasury sector remains under pressure at the end of 2009 with a tremendous amount of new supply required to fund the massive government deficit and perceptions of an economic rebound. **Treasury bonds will represent a larger portion of the Barclays Capital Aggregate Index** which has interesting implications for the future.

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