



## Fixed Income Insight First Quarter 2009

January 21, 2009

### *'Playbook' Still Evolving for this Environment*

#### → *Market Setting*

- ❑ "Fiscal actions are unlikely to promote a lasting recovery unless they are accompanied by strong measures to further stabilize and strengthen the financial system. More capital injections and guarantees may become necessary to ensure stability and normalization of credit markets" – Fed Chairman Ben Bernanke 1/13/09
- ❑ The uncertainty surrounding the scope and magnitude of credit losses on banks balance sheets and earnings that are under attack from a worsening economy continue to foster a turbulent market environment. Originally thought to be contained in the sub prime mortgage market, potential credit losses have now expanded to include student loans, credit cards, auto loans, commercial real estate and a broad range of bank lending activity.
- ❑ The government has been forced to assume a crucial role in the day to day functioning of the financial markets through direct stakes in institutions, direct purchases of securities and indirect provision of liquidity funding. In the past 15 months, the U.S. government has assumed about \$7.8 trillion in direct and indirect financial obligations and lowered the fed funds target by 500 bps. Most of these unprecedented actions have occurred during the past 120 days to avoid systemic risk and attempt to provide stability to the capital markets.
- ❑ Although the current environment is often compared to the Great Depression, there is at least one important difference. US Government spending as a percent of GDP was approximately 3% in the 1920s and the authorities did not fully embrace Keynesian economics. Today, Federal government accounts for approximately 20% of GDP and expansionary fiscal policy is being encouraged by both the central bank and government. Fiscal stimulus under the new administration will likely reach \$1 trillion in 2009.
- ❑ Treasury bonds remain a flight to quality choice for unstable conditions but volatility is expected if government bailout programs are seen as substantially inflationary.
- ❑ Inflation expectations, as reflected by breakeven inflation rates on ten-year TIPs have melted away. At year end, market expectations for annual CPI for the next ten years was a mere 9 bps versus 250 bps last August. For the past year, CPI has been 1.1% while the core rate was 2.0%.
- ❑ The recent 70% drop in oil prices (i.e. \$140 to \$40), if sustained, may act as a powerful force to revive consumer confidence and spending or at minimum, cushion further economic weakness
- ❑ Economic growth prospects are subdued due to continued deleveraging, reduced consumer confidence, weak housing and unemployment which reached 7.2% at years end.

#### → *Outlook*

- ❑ Fed expected to maintain the fed funds target between 0 and 25 bps for a protracted period of time with a possibility of starting a renormalization of monetary policy near the end of 2009.
- ❑ Credit pressures relax somewhat as reflected by a narrowing of the spread between 3 month Libor and Fed Funds from 120 bps to approximately 75 bps during the first quarter.
- ❑ Rates expected to be volatile in the first quarter as the protracted "L" shaped recovery is offset by concerns about the expansionary fiscal policies exerting upward pressure on treasury rates.

### **McDonnell Investment Management – Portfolio Management & Research Teams**

*Please refer to Notes and Disclosures on following page.*



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*Guiding Portfolio Strategies*

## → Outlook (cont'd.)

- ❑ Any upward pressure on interest rates due to the soaring demand for credit by the government is likely to be muted due to the contracting demand and availability of credit in the private sector. Ten year treasuries expected to end the quarter 20 bps higher at 2.4% and near 3% at year end.
- ❑ Spread sectors (corporates, asset backed, and municipals) should do well relative to treasuries. Yields on spread sectors may decline while treasury rates rise. This should create attractive total return opportunities but it is still dependent upon a disciplined and diversified security selection process.
- ❑ Yield curve likely to remain steep for most of the year.
- ❑ While “deflation” and “liquidity trap” concerns may receive attention in the financial press, we expect the economy will skirt the deflation risks seen in the 1930s and in Japan during the 1990s due to aggressive, expansionary fiscal stimulus. Treasury inflation protected securities (TIPs) are a relatively inexpensive insurance policy against inflation rising after 2009.
- ❑ The dollar is expected to weaken modestly as the Fed maintains the funds rate near 0%.
- ❑ Economic risks, although mitigated by the recent government actions, include a sharp rise in unemployment which would worsen the economic crisis and prolong the duration of the current downturn.
- ❑ Equity markets upside likely to be limited by recessionary conditions. First quarter returns are expected to be near 0% before beginning a positive trend in the second half possibly reaching 10+. Higher volatility likely to remain through recession.

## Notes and Disclosures

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