2nd Quarter 2010

Checkers.

To much of the world, it's a simple board game, one reminiscent of children and grandpas, playtime and cold lemonade (or some local variant thereof). You move diagonally across a board of 64 two-colored squares with 24 two-colored pieces. The object, not unlike chess, is to win by either capturing your opponent's pieces, or by blocking them with your own.

But, what if the rules change? What if, for example, the board and pieces were entirely white, allowing no one to distinguish between opposing sides? What if there were not two players, but four?

In a moment, your strategy disintegrates. What was once a clear and certain path becomes a tangle of alternate realities. You move.

Endgame, approximate. You can't count on winning, or losing, if ever you could. You just watch and think of what you might do and what you must do three moves removed.

Welcome to the fixed income markets of today's world.

The players? Amongst the aspirants: the Freddies and Fannies, the regulators, the Fed, the elected representatives, the bond wardens, the home owners and buyers, and on, and on, and on. Each changes chairs as the game unfolds. Each warps the other's moves. Each wants to win, without color.

One does.

Such is our world, and we play a mean game of checkers.

Macroeconomic Review

First-quarter 2010 real GDP gained 2.7% following gains of 5.6% for the fourth-quarter 2009. Primary contributors to the first-quarter gain were the consumer sector, up 3.0%, and inventory rebuilding. Inventories were also a major contributor to fourth-quarter GDP; however, this component of growth will lessen significantly without sustained growth in final demand. While the Federal government sector grew 1.4%, state and local government spending declined 3.8%-the third consecutive quarterly decline. Future growth is going to be dependent upon the private sector versus the public sector given the strains upon the government sector at the federal, state and local levels. The consumer sector will rely upon job growth and a stronger labor market than exhibited so far. The unemployment rate remains high at 9.5% and the long-term unemployed, at 46% of the jobless, portends a weak labor market for the foreseeable future. Our forecast is for a less than consensus growth rate of 2.5%-3% for 2010. This growth rate is well short of booms in a 7%-9% range coming out of previous deep downturns. Core CPI (excludes food and fuel) is up a modest 0.9% during the last twelve months. Potential deflation rather than inflation is more the concern given the substantial slack in the economy.

The European economies are facing weak growth and problematic sovereign debt levels for certain countries. The recent G-20 meeting highlighted the difference between the Euro zone countries emphasizing their deficit/debt levels through greater fiscal constraint even in a weak economic environment. In contrast, the US has placed more emphasis on stimulus spending until the economic recovery gains traction.

The Federal Reserve maintained the fed funds rate at the 0.25% level. The Fed's press release from the recent June 23rd meeting continued to affirm the low level of the fed funds rate for an extended period. Our forecast for modest growth is due to three headwinds. Credit remains constrained. While the monetary base has grown the banks are not lending. The banks would rather invest in US Treasury securities and extend out the positively sloped yield curve. As a sign of distress at the state and local government levels, 207 municipal issuers have defaulted on a total of $6 billion in bonds since July 2009 and the number is expected to increase. Finally, the commercial mortgage-backed securities market is faced with over $150 billion of loan maturities between now and 2012 with approximately two-thirds unlikely to qualify for refinancing due to declines in property values, more stringent underwriting standards and higher interest rates.

Corporate Securities

Investment grade corporate bonds took a breather from their outperformance relative to US Treasuries over the past year. Absolute returns were still positive at +3.42%, but excess returns were -217 basis points as the incremental yield earned over Treasuries grew from an average of 150 basis points to 193 basis points. This was the first quarter of negative excess returns since the first-quarter of 2009. Most of this underperformance occurred in the month of May as markets repriced risk in the face of mounting concern over the potential for European sovereign debt defaults. Financial sector corporate bonds gave back their outperformance on the year. Their underperformance was driven by not only the focus on the exposure of banks to a sovereign debt default in Europe, particularly European banks, but also to the financial regulatory reform bill being debated in the US Congress and the many uncertainties emanating from it for the banking sector.

We took the backup of spreads due to these concerns to maintain or add to our overweight in credit, as we believe many high quality corporate bonds were being unduly punished. We added incrementally to issuers such as Barclays, Deutsche Bank and Telefonica, and opened new positions in BNP Paribas, Bank of NY Mellon, and the Italian utility Enel (3rd largest in all Europe). Our expectation is that corporate earnings will continue to impress, and that the strong and liquid balance sheets of the corporate sector will be maintained as these companies navigate their way through an uncertain economic environment. As some of the larger uncertainties move towards clarity, we think the overall corporate sector will once again outperform.

Mortgage-Backed Securities

Mortgage-backed securities (MBS) total return for the second-quarter was 2.87%, bringing the YTD performance to +4.46%. Although the excess return (versus US Treasuries) was relatively flat on the quarter at +0.1% (+0.72% YTD), MBS outperformed corporate bonds, which had negative excess returns. Overall, mortgages had the best returns to start a year since 2002 as demand picked up in the latter part of the quarter with Europe's sovereign crises driving investors to the safety and relative return Agency MBS provides.

We have maintained our underweight position in the sector established at the beginning of the year. This position was established not only in anticipation of the major and non-economic buyer (Federal Reserve) exiting the market at the end of the first quarter, but also the historically narrow spread pickup over US Treasuries that resulted from the Fed program. We anticipate a better entry point to increase our exposure when spreads widen as the flight to quality trade dissipates in the second-half. Fundamentally we like the sector as tighter underwriting credit coupled with low home prices will lead to limited refinancing and prepayments. However, we will wait for valuations to improve.

MBS rolls continue to offer an attractive carry and yield pick-up versus comparable US Treasury issues. We continue to hold 2003-2005 vintage pools backed by Agency mortgages due to the seasoning of the underlying pools and stricter underwriting standards at the time these mortgages were issued.

In Conclusion

Which leads me to Go, an ancient game of Chinese origin.

Go "is played by two players who alternately place black and white stones on the vacant intersections of a grid of 19×19 lines. Once placed on the board, stones cannot be moved elsewhere, unless they are surrounded and captured by the opponent's stones. The object of the game is to control (surround) a larger portion of the board than the opponent." (Wikipedia, 2010)

While at times a monumentally complex game of war-like strategy, Go is, in essence, not that different from checkers (at least in so far as we have redefined it).

It is played slowly and steadily, and woe betides the hand that falters in the too-eager pursuit of the larger objective. Much like fixed income management.

Forces beyond your or anyone's control create tidal flows and the eddies that confound them. Continents merge and new worlds are born. The landscape shifts beneath your feet, as does your path upon it.

You think and make your plays three times removed. You win (most of the time, at least) and await the next game.