Review and Outlook

January 2011

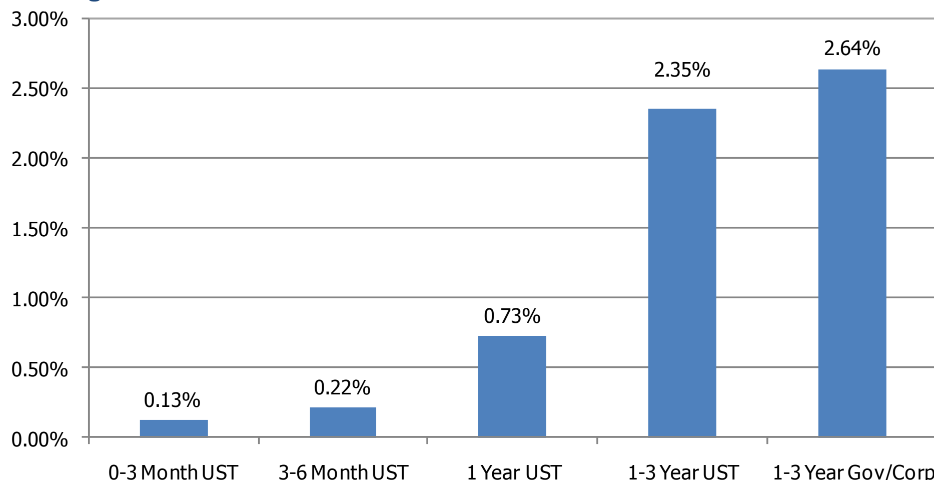
Our themes and recommendations in 2010 centered on the impact of persistently low interest rates and credit risks of weaker financial institutions and sovereigns. These themes materialized in 2010 as the Federal Funds Rate remained exceptionally low and contagion fears in Europe caused credit quality of European banks and sovereigns to deteriorate materially. The high unemployment rate in the US held fast, closing 2010 at 9.4%, leading policymakers to reinvigorate their efforts to facilitate job creation in 2011. The FOMC will be unlikely to reverse its loose monetary policy until there is marked improvement in the labor market. We therefore look to the labor market as an indicator of future FOMC actions and of the likelihood of sustainable higher rates going forward.

2010 in Review

The prospect of low interest rates persisting throughout 2010 and into 2011 led us to recommend that investors extend ultra-short portfolios into high-grade credits (treasuries, agencies, TLGP and select high-grade corporates) further out the yield curve to increase portfolio yield and benefit from curve roll-down. We preferred extending out the yield curve to lowering credit standards as the fragile US recovery and financial shocks in Europe kept us wary of lower-grade credits in 2010.

The fear of rapidly rising interest rates, however, prevented many investors from extending portfolio duration in 2010. These investors missed opportunities to earn considerable returns without having to add credit exposure. The chart below highlights the 2010 returns of five portfolios based on Bank of America/Merrill Lynch index data assuming an investment on January 1, 2010.

Figure 1: Portfolio Returns Indicate Relative Benefit of Extension



Source: Bank of America/Merrill Lynch

Note the relative benefit that investors received through extension further out the yield curve. The 1-year treasury index, for example, resulted in more than three

US Treasuries

As of 31-Dec

Benchmark	Yield
3 Month	0.13%
6 Month	0.19%
1 Year	0.27%
2 Year	0.60%
5 Year	2.01%
10 Year	3.30%
30 Year	4.34%

Bank of America/Merrill Lynch Indexes

30-Nov to 31-Dec

Index	Return
1-3 Yr Gov/Corp ≥ A	-0.16%
1-3 Yr Municipals	-0.17%
1-3 Yr Agencies	-0.10%
0-3 Month UST	0.02%
S&P 500	6.68%

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Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist

times the total return of either of the shorter treasury indices. Based on a $100 million dollar portfolio, the yearly added benefit was $510,000 over the 3-6 month portfolio and $600,000 over the 0-3 month treasury portfolio. Extending from the 1-year treasury index to the 1-3 year treasury index resulted in an additional $1,620,000.

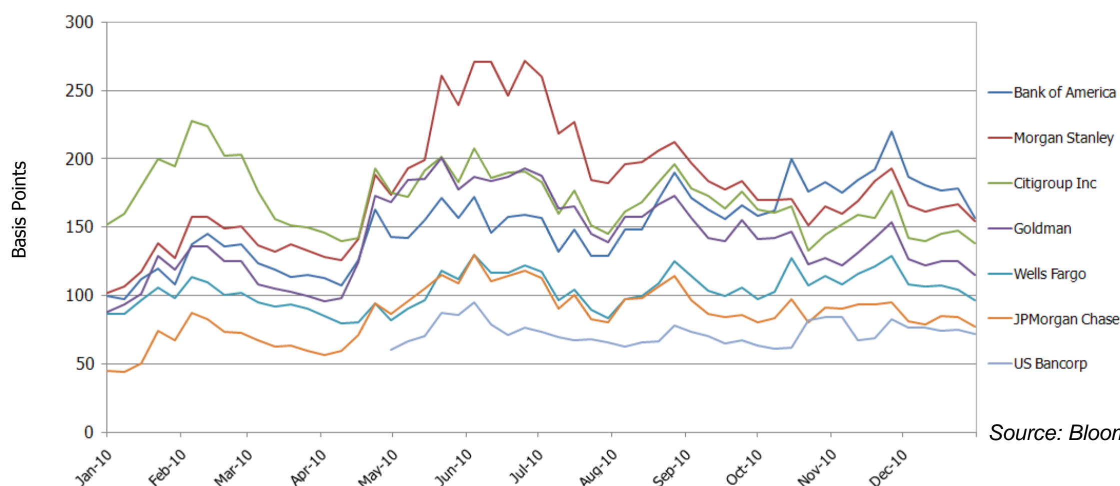
Another important takeaway from the chart is the marginal return that investors received by extending into spread product. The decision to extend into credit is usually an incremental one (i.e., rarely will a corporate cash manager allocate an entire portfolio to credit). Accordingly, we compared the returns of the 1-3 year treasury portfolio and the 1-3 year Gov/Credit portfolio which roughly consists of 60% treasuries, 25% agencies and 15% corporates rated A and higher. This exposure to credit risk resulted in only 29 basis points of additional return, or $290,000 on a $100 million portfolio.

Credit Risks Abounded

Tight credit spreads in high-grade corporates motivated many investors, particularly money funds, to turn to increasingly riskier credits to boost portfolio yields. In 2010 we cautioned against chasing yield by lowering credit standards and recommended avoiding most European and US financial institutions. Though we have not seen any major defaults since Lehman, 2010 was rife with headline risk in the global banking sector.

For much of 2010, U.S. banks were threatened with downgrades as a result of financial reform eventually passed in June 2010. While many banks ultimately received one- to two-notch downgrades of their long-term ratings, the potentially fatal short-term rating downgrade was avoided for even the riskiest of the systemically important banks such as Bank of America and Citi. We also saw another round of the US mortgage crisis in 2010 which centered on banks' exposure to mortgage putbacks and mortgage structured products. New financial regulation and the risks of mortgage putbacks once again called into question the viability of the banking sector's current structure and capital reserves.

Figure 2: US Bank Spreads Experienced Volatility in 2010; 5-year Credit Default Swaps

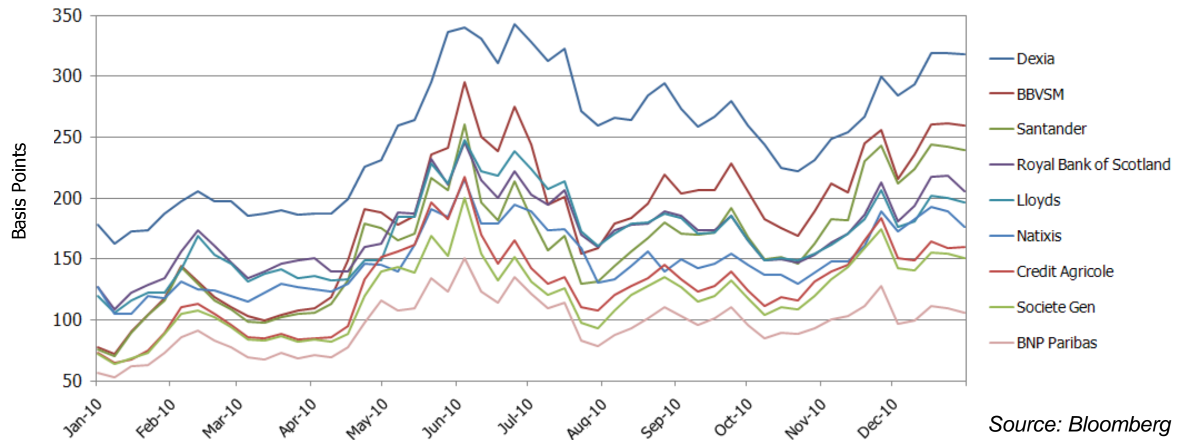


Source: Bloomberg

As bad as the situation in the U.S. looked at times, it paled in comparison to the crisis that was raging in Europe. High debt levels, budget imbalances, souring real estate markets and fear of contagion through cross-country bank and sovereign exposure increased volatility and drove sovereign and bank spreads wider. There is no quick fix to the problems facing Eurozone sovereigns, and resolution of the deep rooted issues will take a combination of austerity measures, debt restructuring and capital injections.

We find no solace in government guarantees on the debt or deposits of the weakest European financials. As we have pointed out in past commentaries, a government guarantee on bank debt obligations is only as strong as the sovereign providing the support; currently, there are few European sovereigns that we trust explicitly. As we learned from Ireland, governments are becoming less able to support their teetering banking sectors. Volatility will continue as events unfold in Europe.

Figure 3: European Bank Spreads Have Continued to Widen Throughout 2010; 5-year Credit Default Swaps



Source: Bloomberg

Outlook for 2011

The Federal Funds Rate will remain exceptionally low throughout 2011 as the Federal Reserve attempts to combat stubbornly high unemployment at the risk of future inflation. Chairman Ben Bernanke has long made clear, through his roles in academia and at the Fed, his significant aversion to repeating Japan's mistake of tightening too quickly. Thus, we expect the Fed to err on the side of keeping rates too low for too long.

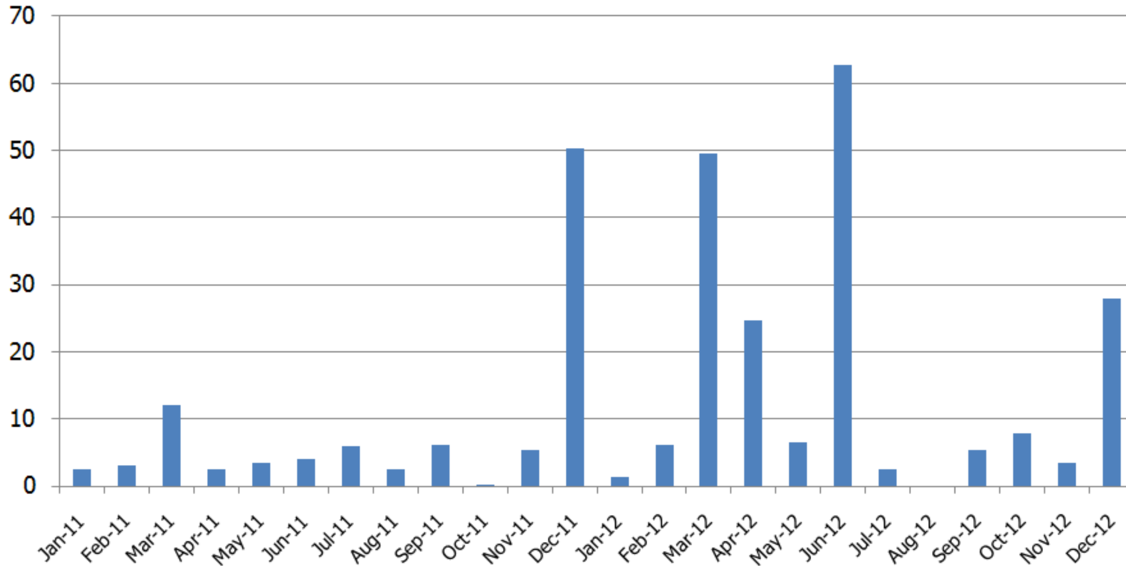
Despite recent positive economic data, the struggling labor and housing markets will continue to weigh on the economic recovery in 2011. While the headline unemployment rate gets much of the attention, other broader gauges of unemployment highlight the depth and severity of the labor market's woes. The U-6 estimate, which includes those workers marginally attached to the labor force and employed part-time for economic reasons, remains historically elevated at 16.7%. Ben Bernanke recently testified in front of the Senate Budget Committee that it will take four to five years for the labor market to normalize.

The huge backlog of foreclosures and government policies aimed at buoying up the housing market will postpone equilibrium in the market for years. This implies further downside to home prices and subdued inflation as housing constitutes roughly 40% of inflation measures that the Federal Reserve monitors. Low observed inflation combined with high unemployment and tame inflation expectations will likely keep the Federal Reserve on hold through 2011.

Agency and TLGP Paper Roll Off

The end of 2012 will mark both the maturity of all remaining debt issued under the Temporary Liquidity Guarantee Program (TLGP) and the scheduled expiration of the Treasury's unlimited solvency support agreement for Fannie Mae and Freddie Mac. Given that a significant portion of most 1-3 year portfolios is allocated to these two sectors, these events will require that investors reevaluate their portfolio sector allocations in 2011.

Figure 4: TLGP Maturity Profile to Program Expiration, $ Billions



Source: Bloomberg

The TLGP was effective at providing temporary liquidity to the market, but its expiration will result in large refinancing needs for US financial institutions. As many buyers of TLGP paper will not likely reinvest maturing FDIC-guaranteed securities in non-guaranteed financial debt, bonds with a risk profile similar to FDIC paper will need to be sourced to fill this void. Buyers of agency debt may encounter a similar predicament with the scheduled expiration of support programs for the Government Sponsored Entities (GSEs), Fannie Mae and Freddie Mac. While the supply of agency paper will not be limited as it will be with TLGP paper, the changing risk characteristics of agency debt maturing beyond 2012 must be given adequate attention.

No decision has yet been made regarding the relationship the government will maintain with the GSEs beyond 2012. Restructuring these entities is a stated priority of the newly elected Congress, but we do not expect it to be completed quickly. Potential outcomes range from privatization to outright government ownership. We are not attempting to predict the fate of the GSEs, nor are we suggesting that investors avoid them entirely beyond 2012, but we are recommending that investors be aware of the dynamic risk profile.

Risks to our Call

The primary risk to our call of persistently low interest rates in 2011 is a real economic recovery that is stronger and quicker than expected. This would be accompanied by a significant drop in unemployment and a convincing recovery in the housing market, both of which would need to be sustainable, not merely upheld by intervention of non-market forces. Higher-than-expected inflationary pressures leading to a rapid rise in rates would also present a risk to our expectations, but once again, this would be accompanied by sustainable indications of a broader economic recovery.

An interesting wildcard this year is the potential increased politicization of the Fed, with Representative Ron Paul taking over as the new Chairman of the US House Financial Services Subcommittee on Domestic Monetary Policy and Technology. Rep. Paul, author of *End the Fed*, could be a loud critic of QE2 and the current rate policy, diminishing the independence of the Fed and perhaps keeping Chairman Bernanke from having his way on easy monetary policies.

Looking Forward

2010 has come and gone, leaving legacy of low short-end rates that will persist well into 2011. Investors should look to take advantage of interest rate volatility as the market learns to balance positive economic indicators pointing to signs of recovery with the Federal Reserve's commitment to keeping rates low. Marked improvement in the labor market will be the true indicator of the speed with which the FOMC will reverse its loose monetary policy.

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