# MARKET Commentary

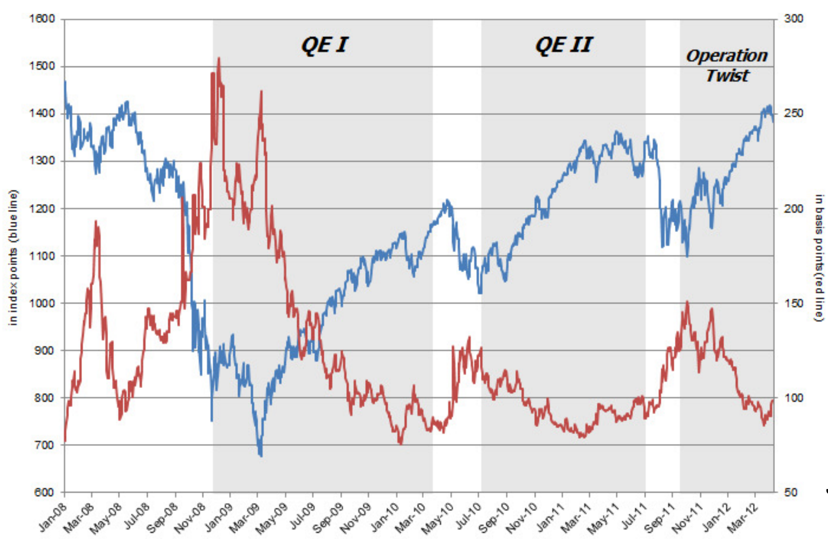
## The Convexity of Credit

The "risk-on" trade continues to be the story of 2012. Credit spreads have now recorded four consecutive months of tightening, and the credit euphoria has inspired a global wave of new issuance of corporate bonds. Despite strong economic headwinds in Europe and the U.S., sustained global accommodative monetary policy supports our thesis of the positive "convexity of credit" in 2012, or the belief that credit will continue to perform well in both positive and negative economic scenarios. Short-duration investors will find value in maintaining a defensive overweight in credits with attractive carry and steep curves, while also taking advantage of short-term market volatility caused by continued negative headlines in Europe and the U.S. to further build positions. As in past periods of potential interest rate volatility, we recommend that investors remain duration neutral and opportunistic of sudden rises in interest rates that are incongruous with the FOMC's stance that rates will remain exceptionally low until late 2014.

## Risk-on Continues

The risk-on trade in 2012 has been impressive. Global central bank coordination has been supportive of credit, and liquidity introduced under the guise of an alphabet soup of government programs—the most prominent being the European Central Bank's Long-term Refinancing Operation (LTRO) and the Federal Reserve's Quantitative Easing Program (QE I, QE II and Operation Twist)—has driven risky assets to relative highs. For the period Q1 2012, the S&P 500 is up 12.59%, the VIX has fallen 33.76% and credit spreads as measured by the 5-year Investment Grade CDS index have tightened 22.95%.

**Figure 1: FOMC Accommodation Fueled Asset Boom: S&P 500 (Blue Line/Left Axis) & IG 5-Year CDS Index (Red Line/Right Axis)**




*Source: Bloomberg*

*April 2012*

### US Treasuries

**As of 30-Mar**

| Benchmark | Yield |
|---|---|
| 3 Month | 0.07% |
| 6 Month | 0.13% |
| 1 Year | 0.17% |
| 2 Year | 0.33% |
| 5 Year | 1.04% |
| 10 Year | 2.21% |
| 30 Year | 3.34% |

### Bank of America/Merrill Lynch Indexes

**29-Feb to 30-Mar**

| Index | Return |
|---|---|
| 1-3 Yr Gov/Corp ≥ A | 0.03% |
| 1-3 Yr Municipals | -0.06% |
| 1-3 Yr Agencies | 0.01% |
| 0-3 Month UST | 0.01% |
| S&P 500 | 3.29% |

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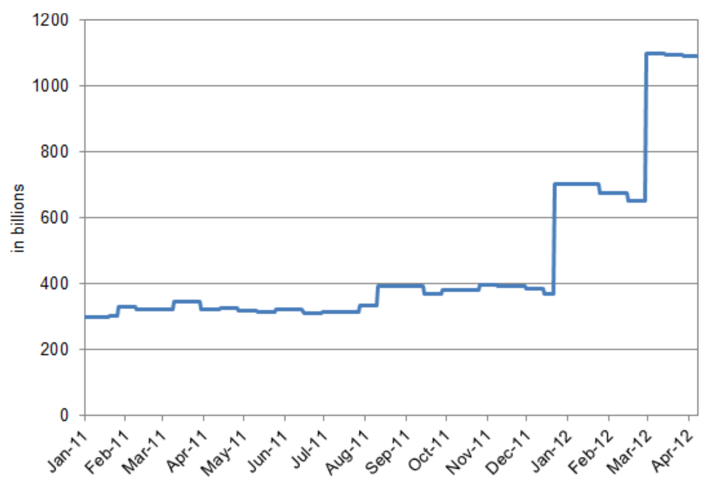
Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist, S&P and Center on Budget and Policy Priorities, Wall Street Journal

Global corporate issuers have taken advantage of the favorable credit conditions in Q1 2012 to issue a quarterly record of $1.16 trillion worth of corporate bonds, surpassing the previous record set in 2009. What makes this surge of issuance even more impressive is the lack of government-guaranteed debt which was so prevalent in 2009. In the U.S. alone, $124 billion of term debt was issued by U.S. financial companies under the FDIC's Temporary Liquidity Guarantee Program in Q1 2009, with similar programs en vogue in Europe, the U.K. and Australia.

At first glance, what is decidedly constructive for global corporations seeking to issue debt (relatively tight credit spreads and low absolute interest rates) would seem to the detriment of credit investors. This, however, is not the case. Credit investors are relishing the ability of corporate issuers to tap markets for term funding, and the appetite for risk assets by investors has been insatiable. Bond mutual funds and bond ETFs have seen exceptionally strong inflows during Q1 2012 helping to buoy bond prices.

The sheer amount of liquidity in the system introduced by global central banks has a fair amount to do with the continued strong demand for risk assets. The ECB's LTRO, which allows European banks to borrow 3-year term funds at an artificially low rate of 1 percent, recorded in its two auctions a combined 1,323 banks applying for and receiving €1.1185 trillion in loans. LTRO funds are being used to fill balance sheet holes created by fleeing retail and institutional depositors as well as jittery interbank lenders, which European banks have historically utilized for a large portion of their funding needs.

**Figure 2: Aggregate Borrowing Under the ECB's LTRO Program**




*Source: Bloomberg*

While €1 trillion in direct lending by the ECB to European banks seems drastic, it may ultimately be a small price to pay to halt the forced deleveraging of banks struggling to fund operations in the face of volatile borrowing costs. The ECB rightly recognizes that in the current environment a widespread deleveraging of banks would result in a further fall of asset prices and a dramatic rise in sovereign, corporate and consumer interest rates. No one knows better than the ECB the symbiotic relationship between sovereign debt issuers and sovereign debt buyers; the success of both being critical to resolving the systemic and growing European debt crisis. The LTRO and other ECB policies to provide sovereigns and banks with increased access to cheap funding has been, and will continue to be, positive for credit in 2012.

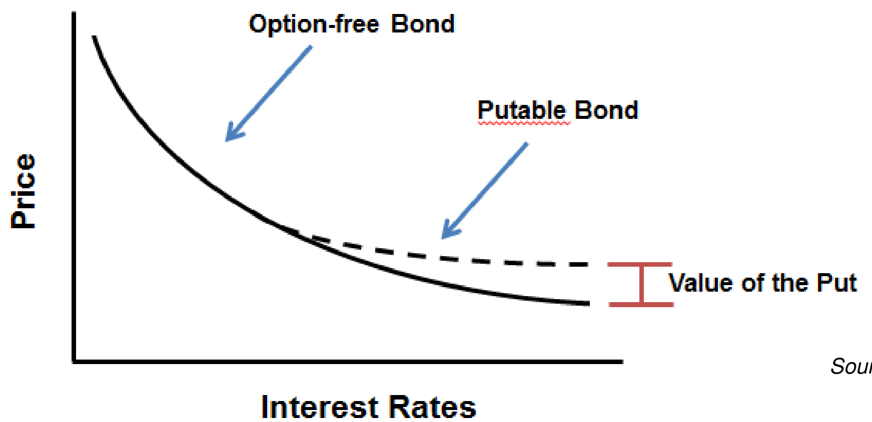
The added liquidity, however, does not seem to be having the ancillary trickle-down effect of spurring real lending in Europe. In the Eurozone alone, Slovenia, Portugal, Cyprus, Italy, Ireland, Czech Republic, Belgium and the Netherlands have all dipped into a technical recession, with many more systemically important countries likely to join them in the next round of quarterly economic releases. Spain, which has received the majority of negative press recently, boasts the highest unemployment rate among Eurozone countries at 23.6 percent, with an unemployment rate for workers under 25 years of age exceeding over 50 percent. Clearly, this is not sustainable.

Federal Reserve Chairman Ben Bernanke said it best when he stated that "central bankers alone cannot solve the world's economic problems." We recognize that no amount of central bank liquidity can overcome the long-term need for fiscal prudence and austerity, which seems at odds with policymakers' hopes for a broad-based economic recovery. The continued difficulties and failures of sovereign governments to lower absolute debt levels, balance budgets and encourage economic growth leave us acutely aware of the numerous risks that remain to the broader market. While these risks will certainly contribute to the volatility we expect to see in 2012, the proven willingness of the Troika (the ECB, EU Commission and the IMF) and other central banks to support the market through further policy actions will dictate the ultimate direction of markets in the near term.

## The "Convexity of Credit" Explained

For this reason, the current environment lends well to the continued performance and relative attractiveness of credit. The "convexity of credit" is positive in our view, with credit performing as expected in a positive economic scenario and better than expected in a negative economic scenario due to central bank intervention. We liken this idea to performance characteristics of a putable bond, where the holder of a bond benefits in market strength and has added protection (an option to "put back" the bond to the issuer when bond prices decrease in value) in times of market weakness.

**Figure 3: Example of the Putable Bond; In Current Environment, Credit has Imbedded FOMC Put Option**



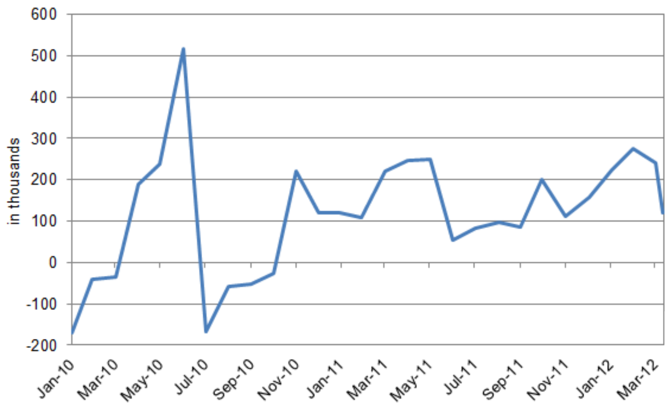

*Source: Clearwater Advisors*

On one hand, systemic risks in the U.S. are diminishing. The Federal Reserve released the results on its recent stress test of U.S. banks, with only a handful of banks failing to meet capital requirements based the Federal Reserve's overly pessimistic economic assumptions and bank plans for capital distribution to shareholders in the form of dividends and stock buybacks. The positive stress test results confirmed that, while bank business models remain under pressure, balance sheets are generally improving. Greater systemic stability of the U.S. banking system results in a diminished discount for "tail risks" that could result in widespread market disruption like that seen in 2008. This is supportive of credit.

On the other hand, numerous headwinds to the global economic recovery remain and could introduce volatility in the near term. After encouraging economic numbers in the U.S. in January and February, March's figures proved disappointing. The large majority of economic releases in March simply met or missed consensus estimates, with the most prominent being the March job report showing that only 120,000 jobs were gained in March, compared 200,000 plus jobs added in both January and February. Rising oil prices, weak corporate earnings, flare ups in

Europe and looming downgrades of global banks could introduce additional volatility into the broad market. Indeed, we have already begun to see a slight reversal of credit spreads from the lows of the year reached on March 15, 2012.

**Figure 4: Monthly Non-Farm Payrolls Take A Significant Step Backwards**




*Source: Bloomberg*

Of the two economic scenarios outlined, pronounced economic strength or weakness, we continue to believe the latter is more likely. This means that the road to realizing our view of tighter credit spreads in 2012 could be a bumpy one. The FOMC has indicated and proven, however, that they are willing to provide additional accommodation if the economic recovery slows or falters. The "Bernanke Put," as the market has come to call it, is very much alive and well.

Policy actions by the Federal Reserve could continue to support credit spreads despite weakening economic fundamentals and deteriorating credit conditions. This was the case in QE 1, QE II, Operation Twist and will likely be the case if QE III is ever needed, which seems more likely with every passing day. While interest rate and credit spread volatility will remain, we believe that the market will continue to set relative lows in credit spreads in 2012. As such, we recommend that investors retain their bias for less volatile financial (i.e. avoiding names with idiosyncratic risk) and strong industrial credits to prudently monetize this view.

## Looking Forward

The current environment will reward investors who are able to take advantage of market volatility that is incongruous with the view that the FOMC will remain on hold to 2014 and that credit spreads will remain tight or continue to tighten in 2012. Despite recent economic figures that point to a nascent recovery in the U.S. and abroad, the Federal Reserve and global central banks have shown a propensity to support the market if the recovery were to falter. We recommend that investors do not attempt to "Fight the Fed," and look to maintain a long bias in less volatile financial and strong industrial credits where absolute yields and steep curves are attractive.

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