Observation Deck

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Bond.com?

Hiroshi Ikemoto, *Money Market Trader*

There has been much discussion about the recent rally in the bond market, primarily in U.S. Treasuries, with some observers labeling it as the next "Bubble." Many analysts have pointed out similarities between the frenzied atmosphere during the Internet and technology bubble 10 years ago, and the more recent global housing bubble. The speculation is that the amount of money being poured into the bond market is unsustainable, and that eventually there will be a massive sell-off, with investors taking heavy losses. Nothing like putting fear into investors who are in the bond market because of fear…

But what exactly is a bubble? In the simplest financial terms, a bubble occurs when an asset transacts in higher-than-normal volume and at prices that are substantially higher than its enterprise value. Recall that the technology and real estate bubbles were sparked by the huge potential for significant short-term capital gains, amid a strong economy and easy access to cheap cash. As prices sharply rose, more and more less-sophisticated investors entered the markets, bidding up prices further still. Eventually and suddenly, participants questioned these inflated prices, deemed them artificial and sold their assets at whatever they could get, leaving the last ones out holding depressed assets.

The main difference between past bubbles and the current situation in the bond market is that this rally is driven mainly by pessimism in the economy, not on optimism for growth. The high demand today for Treasuries stems from fears that the U.S. economy will continue to slump for a substantial period, prompting speculation of deflation and a double-dip recession. The Fed has given no sign that it will raise interest rates in the foreseeable future, and recent economic data has been generally weak, especially for the lackluster labor market. Investors in the fixed income sector are looking for return, but it has become more of a priority to preserve capital. Historically, U.S. Treasury securities have been the asset of choice for return *of* capital, versus return *on* capital.

Only two factors can burst a bond market bubble: Inflation and the widening of credit spreads. The former is defined by economic growth and monetary policy in response to economic activity. The latter is the perception from the market participants on how much more yield an investor would receive for taking on credit risk.

To really test what a "bond bubble" would entail, let's compare the tech bubble against the current 10-year Treasury note. From March 1, 2000 to May 31, 2000, the NASDAQ index fell 28.88 percent. Conversely, a 10-year Treasury note purchased at 2.50 percent today would need to reach 6.70 percent by the end of November for the same level of loss. Such a move would require an extremely dramatic rate hike by the Fed, considered highly unlikely. Or it would require a similarly dramatic investor fear of a U.S. government debt default — and if this were to happen, investors would do better to load up on firearms and canned goods. Game over.

The point is that any sudden yield spikes will cause some damage to the total return of a bond portfolio. However, these debt securities will eventually mature at par and any impairment will be temporary as prices adjust to the volatility. U.S. debt remains the investment of choice worldwide, especially in times of duress. This translates to the U.S. government's ability to continue issuing debt at extremely favorable rates, as buyers remain confident that the U.S. provides the safest alternative and the most solvent government globally.

Markets

Treasury Rates	
3-Month	0.13%
6-Month	0.18%
1-Year	0.23%
2-Year	0.47%
3-Year	0.69%
5-Year	1.33%
7-Year	1.92%
10-Year	2.47%
August Total Returns	
ML 3-Month Treasury	0.01%
ML 6-Month Treasury	0.04%
ML 12-Month Treasury	0.09%
S&P 500	-4.74%
Nasdaq	-6.24%

Source: Bloomberg, as of 08/31/10

Economic Vista

Debra Hanson, *Portfolio Manager*

August started on a bad note, as the government released the data on personal spending (0.0 percent), initial jobless claims (479,000) and nonfarm payrolls (down 131,000). Nonfarm payrolls and personal spending both came in lower than expectations and set the tone for the rest of the month. Nonfarm payrolls dropped for the second month in a row, after five months of job creation. The government also revised the previous month's number downward, from a loss of 125,000 to a loss of 221,000, for a double whammy on the job front. Initial jobless claims hit 500,000 mid-month, well above the one-year low of 427,000 in early July. Retail sales were reported mid-month as up 0.4 percent, but after taking out autos and gas the number fell to a drop of 0.1 percent.

Pending home sales were down 2.6 percent month over month in June and down 20.1 percent year over year. Existing home sales dropped 27.2 percent in July from June, while new home sales dropped 12.4 percent in July from June and 32.4 percent from the same time last year. With mortgage rates at these extremely low levels (about 4.4 percent) there is a lot of refinancing. Unfortunately, you need to have a job in order to refinance your home, so this does not help all of those adults out of work.

The ABC consumer confidence numbers have been dropping steadily over the month. Consumers need to "feel" the economy is recovering which in turn will bring confidence up and spending back.

The good news is that inflation is not a concern at this time, and this has allowed the Fed to keep interest rates low.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

Credit default swaps on Irish government debt surged over 200 basis points from March through August 24, according to data provider CMA, showing increasing investor concern that the cost of rescuing Anglo Irish Bank will exceed the maximum 25 billion euros forecasted by the Irish central bank. Subsequently, Standard & Poor's lowered Ireland long-term credit rating to AA- from AA, due to S&P's expectation that a rising cost of supporting the Irish financial sector will further weaken the government's fiscal flexibility over the medium term. S&P has increased the estimate of the cost to the Irish government of recapitalizing financial institutions to 45 to 50 billion euros, (29 to 32 percent of GDP), from 30 to 35 billion euros (19 to 22 percent of GDP).

This event underscores that the market's ongoing reaction will be an important factor in shaping the operating environment for European banks and the respective sovereign debt. The European Union is considering more frequent stress tests to bolster confidence in the region's banking industry. On July 23, the EU stress test results showed that seven of 91 banks failed the test, because their Tier 1 regulatory capital ratios were below 6 percent after incorporating the most severe loss assumptions from the Committee of European Banking Supervisors (CEBS). While the test results provided greater transparency about lender's holdings of sovereign debt, they were criticized for not being stringent enough, as those failed banks were shown to need only 3.5 billion euros of new capital, about one-tenth of the lowest analyst estimate. Among the banking groups that passed the test, 17 of them did so by a relatively thin margin. The evaluations took into consideration potential losses only on government bonds on the trading book, rather than those that are being held until maturity, as the case for most banks' holdings of sovereign debts. In addition, funding and liquidity were not directly considered in the test. Going forward, we can expect greater selectivity in investor decisions, favoring banks and sovereigns that have improved their risk profile and have strong funding position.

Trading Vista

Minh Trang, *CFA, Portfolio Manager*

Just when you thought rates couldn't drop further, the bond market again tested historic lows in August, driven by continued weakness in the overall economy. The Treasury 10-year fell from 2.91 percent at the beginning to 2.47 percent by month's end. The drop in the shorter part of the curve was less dramatic. The two-year slipped 8 basis points to end the month at 0.47 percent, and the one-year declined 4 basis points to close at 0.23 percent. Government agency debt kept pace with the decline. Agency yields were plus 8 basis points in the one-year area and plus 11 in the two-year curve over Treasury.

Corporate spreads remain tight, even as LIBOR continues to decline. The one-year forward LIBOR dropped 5 basis points to 0.41 percent by the end of August. Industrial names continue to trade very rich, as inventory under six months maturity remains sparse. Financial issuers have also traded tighter, with one-year debt at plus 20 basis points over Treasury and two-year at plus 35.

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