“The Most Colossal Ever”

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A look at the returns of risk-based assets so far in 2009 can take one’s breath away. To some degree being “long beta” seems have been the only script to follow this year, and fixed income assets participated in this “epic movie” with a vengeance. In fact, such returns prompt this normally staid bond geek to recall the taglines of the Technicolor movies of the 1950s. “The Entertainment Experience of a Lifetime!” “The Greatest Event in Motion Picture History!” and “The Most Colossal Ever” come to mind.

What did these all cinematic spectacles have in common with our recent near-death capital markets experience and the breathtaking recovery? A glib observer might insert Ben Bernanke into a title role in *Quo Vadis* and have Timothy Geithner featured in *The Ten Commandments.* Indeed, a fertile mind could even tease some (un)flattering roles out of Spartacus for a handful of our elected officials and/or bankers. Even now as we look back at these old films through the jaundiced eyes of our age, we can sense the awe they inspired in an era of grainy black-and-white TV. And, personally, I am in awe of the excess returns witnessed in the fixed income markets through November 30, 2009.

With returns like those of the last ten months, many have paused and asked “where are we going from here?” Although there is the potential for short-term pressure on high-yield and investment-grade credit as levered investors unwind winning trades as year-end approaches, we believe that the longer-term outlook for credit-sensitive bonds is favorable. While the 2010 excess returns may not be as thrilling as a chariot race around a stage set, the prospects include declining new issuance, steady demand from retail and institutional investors, and improving fundamentals. Even the widely feared dollar decline has positive implications for U.S.-based multi-nationals and the export sectors of our economy.

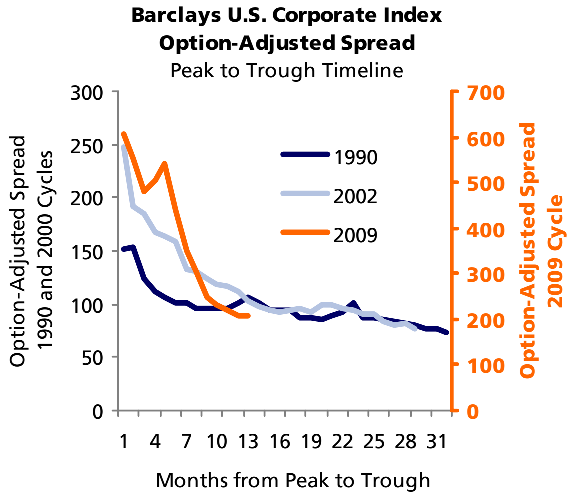
After a heady year like 2009, we sometimes forget that a regular coupon and declining risk premia, or tightening spreads, often make for a satisfying fixed income return set. Naturally, our outlook is based on a modest economic recovery coupled with the gradual removal of quantitative easing and ZIRP (zero interest rate policy). Capital markets history — as opposed to Hollywood epics — point to a number of compelling reasons to remain long credit risk strategically. Indeed, the tightening of spreads tends to continue for some time after the sort of risk aversion that we witnessed during the recent banking crisis.

Awe-Inspiring YTD Returns from Risk-Based Fixed Income

Year-to-Date Excess Returns (as of 11/30/09)			
Industrial	**%**	**Quality**	**%**
Basic	30.40	Aaa	1.54
Capital Goods	18.33	Intermediate	2.32
Communications	21.50	Long	-3.84
Consumer Cyclical	24.93		
Consumer Noncyclical	16.83	Aa	10.46
Energy	24.52	Intermediate	8.86
Technology	19.86	Long	16.02
Transportation	23.39		
Utility		A	17.36
Electric	23.96	Intermediate	15.18
Natural Gas	33.07	Long	24.07
Financial			
Banking	15.93	Baa	28.79
Brokerage	28.38	Intermediate	26.25
Finance Comp.	13.41	Long	35.32
Insurance	29.64		
REITs	55.07		

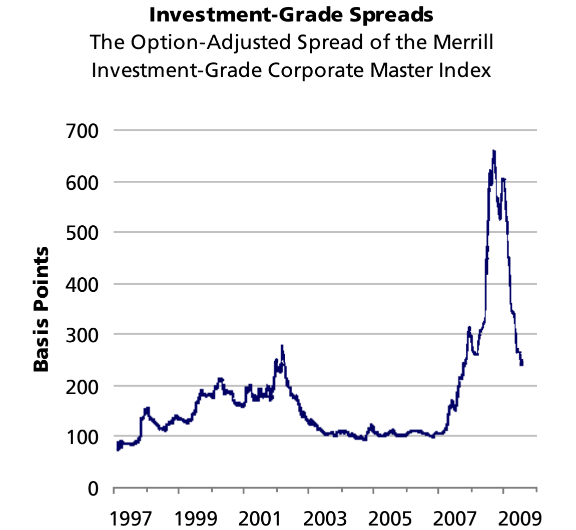
Source: Barclays Capital

Comparison with Historical Peak-to-Trough Timelines Offers Support



Source: Barclays Capital

Investment-Grade Spreads Still Have Room for Additional Tightening



Source: Bianco Research

I view the long peak-to-trough data as a wind at the back of credit markets — as well as good news for the oarsman in the galley scene from *Ben Hur!* Coupled with the likelihood of yield-starved retail flows from money market funds and increased pension fund allocations, this steady breeze is a good omen for corporate bonds. But as with any good script, the story will not unfold without some twists and turns. One might expect potential risk scares emanating from anxiety about the dollar, a stall-out in the housing market recovery and uncertainty about the timing and magnitude around the eventual removal of liquidity by the Federal Reserve, to name just a few.

The recovery in spreads following the dot-com bust — remember WorldCom and Enron? — may be a helpful example, especially since today's spreads are just inside the wides experienced back in 2002, and investors who hesitated to get back into the credit markets after the initial 2002 rally missed subsequent excess returns. So, before you flip channels to Turner Classic Movies to watch a "sword and sandal" re-run, check out this potential re-run that might be featured on CNBC next year. ■