

# F.I.R.S.T

## Fixed Income Research and Strategy Trends



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“The economy is expanding again, and the important question is if the recovery process is to the point where we might witness self-sustaining growth.”

## The Concern About Rates

A year ago we were amidst the worst of the economic and market conditions. Happy New Year, indeed. The economy is expanding again, and the important question is if the recovery process is to the point where we might witness self-sustaining growth. This is the focus of the bond markets, as interest rates have risen over the last month. Coupled with some recently improved economic data, the staggering financing needs of the government and the prospect of the unwinding of accommodative policies, the “rising rates camp” is inhabited by many market participants that envision not only an upward path for rates but inflation fears as well.

The improvement in economic data includes important signals that are coming from the financial markets themselves. Risk has been embraced, in varied markets, and the yield curve has steepened to record levels. In recent months, markets have been very reliable indicators of turns in the economic outlook. These markets are also starting to focus on the unsustainable fiscal policies. The government is funding not only stimulus to address the cyclical downturn but also an expansion of the role of government itself. Further, unfunded health and retirement mandates loom. It all adds up, and the bond market vigilantes may be back on the government’s case about it.

Another “camp” reminds us that credit conditions still remain difficult and reversal of the Fed’s posture would be premature. Commercial and residential real estate are still weak and foreclosures in both will accelerate in 2010, maintaining an abundant shadow supply overhanging all of real estate. The stubbornly high unemployment rate will also hamper sustained recovery. Less talked about, the necessity of continued deleveraging has been keeping private sector borrowing at bay. While government issuance has soared, consumer credit is anemic and — costs cut to the bone — businesses are profitable, forgoing any need for them to access markets. These are all disinflationary forces and provide for limited upward pressure on interest rates.

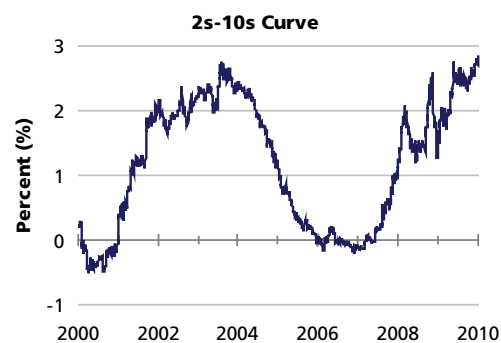
Between these two views, there seems little middle ground, and advocates of each appear to have dug in. The magnitude of the risk of being on the wrong side is high. The steepness of the yield curve likely

### Ten-Year Treasury Yields Moved Higher in Late 2009.



Source: Barclays Capital, U.S. Treasury

### Ten-Year to Two-Year Treasury Spreads Show a Steeper Yield Curve, as Shorter Rates Are Held Down by Fed Policy.



Source: Barclays Capital, U.S. Treasury

reflects these immediate concerns holding down short rates, while longer term fears are boosting long rates. Something has to give. We propose that the slow recovery scenario is the stronger story. But to express this in terms of interest rates: Can the economy tolerate higher rates? Higher rates might benefit pension plans and the interest margin book of

business at banks, but they would hurt consumers and further punish real estate. The bulk of foreclosures and defaults on homeowners that are upside down on their mortgages have yet to be realized. Half of the toxic assets still need to be written down by financial institutions.

Finally, consider that the best economic times in recent years were driven by a consumer spending surge and a housing boom. Neither of these is going to be much of a factor in growth in the near term. Replacing the consumer, could we have a resurgence in industrial investment — more plant and operating capacity? Probably not, as we are awash in excess capacity. A growth in exports? Yes, definitely, but not enough to move our GDP, especially when China won't allow its currency to adjust. The cycle of global imbalances that witness Chinese savings being reinvested in U.S. debt has not been broken and remains a bedrock cause of global instability.

We agree that the aggressive fiscal and monetary initiatives have provided a healing process that has created a turnaround in economic growth. But we don't have a cure yet for private and financial balance sheets, real estate and joblessness. The impact of these will be with us for some time, causing economic growth to be below capacity. Decades of excess borrowing and spending simply won't be worked off quickly.

Yes, there are going to be good economic reports and the economy will claw back — nothing moves in a straight line. Inventory restocking is additive, though it is moving faster than final demand is. Enough doubts exist about the path of economic growth to make us question December's selloff in Treasuries. Our view is that although some macro data has improved, the U.S. economy is slated for a slow recovery that should be supportive of credit exposures and fixed income investments in general. ■

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