February 2010

ING Market Intelligence Series

F.I.R.S.T

Fixed Income Research and Strategy Trends

Richard Kilbride,
Head of Fixed Income
Managed Accounts

"We should not underestimate how long it will take for new regulations, policies and taxes to be implemented; the uncertainties around governmental actions likely will be with us for some time."

Awaiting the Breakout

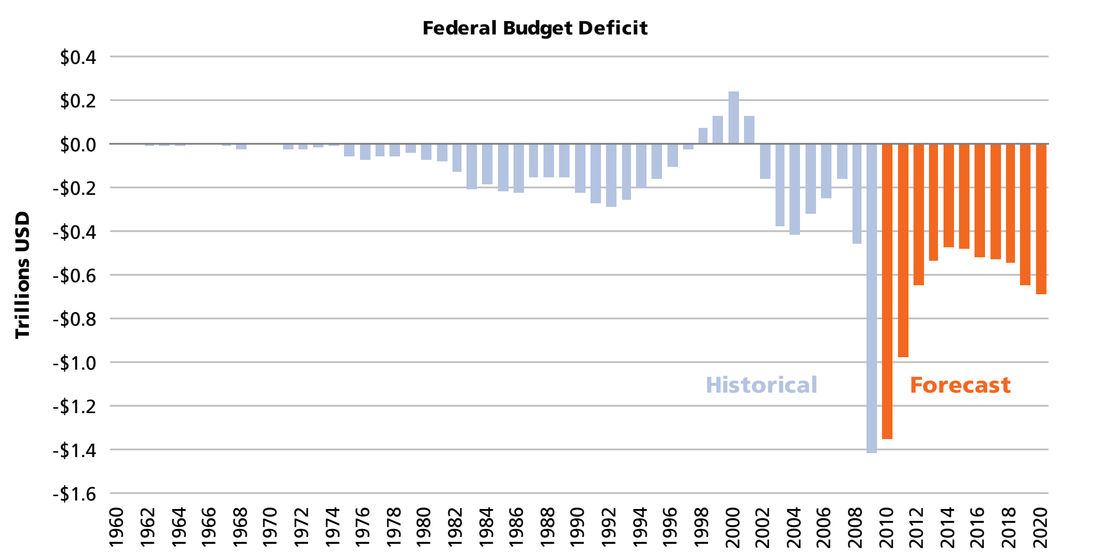
Something has to give, but whatever it is, it probably won't happen right away. Such instant gratification isn't the way of the markets. A more drawn out and painful waiting process is more typically required. Treasury Secretary Geithner, needing to borrow as much as $1.4 trillion, refers to the relentless budget deficits as far as the eye can see as "a corrosive threat to our economic future". Bond rates shrugged: It's not news. The government's needs and the Treasury's enormous funding plans are well known. Treasury rates remain below both December's levels as well as the higher yields of June 2009.

Auctions in late January for two-, five- and seven-year Treasuries of record sizes came without any disruption. The federal deficits, $4 billion per day, continue to be financed with seeming ease. At the same time, private credit needs have faded remarkably. Inventory financing, working capital financing and bank lending have all diminished, and new corporate debt issuance is less than maturing securities. Microeconomic factors — supply and demand — have worked favorably for the credit markets.

The macroeconomic story is more mixed, at least from here. This is where the irresistible forces are up against the immovable objects. Clearly, there have been enormous amounts of stimulus applied to global economies. With economic activity cut back as drastically as it was, improvement, of some sort or another, may be the only reasonable direction. Further, increasing corporate profits reflect this bounce from the bottom, and credit markets — at least for global firms — are effectively back to normal.

On the other side, the financing mechanisms for the economy as a whole are far from normal. Banks are recapitalizing but remain wounded with non-performing assets: The full measure of loss recognition and deleveraging has not run its course. Small businesses are not getting funding. State and local budgets remain in serious trouble. Consumers are expected to maintain the shift to more saving, impacting ongoing consumption. Further, real estate isn't better, and commercial real estate continues to fade.

Historical federal budget and the bleak forecast



Source: U.S. Treasury, Congressional Budget Office

The consensus is clearly that the upper hand goes to the economic improvement story. But the markets, which have been great predictors of economic events of late, have become much more defensive. While three-fourths of the fourth quarter earnings reports released thus far have surprised on the upside, equities have paused, the tightening of corporate spreads has stalled, and rates are certainly not exhibiting fears of rampant recovery. Instead many going concerns, and banks and small businesses particularly, are frozen in the headlights of developing regulatory and tax environments. Many of the government initiatives, especially the tax hikes, are explicitly anti-growth and indicative of the uncertainties influencing commerce and markets. We should not underestimate how long it will take for new regulations, policies and taxes to be implemented. Thus, the uncertainties around governmental actions likely will be with us for some time.

We watch inflation and employment reports carefully for directional changes. The Fed will maintain accommodation at least into the summer. If final demand supports the economy by then, we would begin to experience the removal of accommodative monetary policy. At that time, we will have an honest conversation as to whether inflation is a prospective threat. But this is for another day. Meanwhile, interest rates are not gapping higher, and some recent reordering of credit valuations provides relative value opportunities. ■