



# MARKET AND STRATEGY UPDATE



Steven A. Walsh Co-Chief Investment Officer, Western Asset Management

- We do not feel that a lot has changed underneath the recent volatility
- Inflation should remain benign in the short term, but is a concern longer-term
- We expect the Fed to remain accommodative, however some uncertainty over monetary policy will remain
- We believe interest rates have largely completed their re-pricing





Stephen A. Walsh
Co-Chief Investment Officer

# Webcast Summary

# Market and Strategy Update

# What is the backdrop for recent fixed-income market events?

- On May 22, Federal Reserve (Fed) Chairman Ben Bernanke testified that the Fed could begin to taper its asset purchase program within its next few meetings
- This helped to precipitate the volatility and uncertainty we've seen over the last seven weeks
- Prior to Bernanke's statement, the economic landscape could be described by three characteristics:
  - Modest global growth
    - Not fast enough to worry about central bank tightening; not slow enough to worry about recession
  - Benign US inflation
    - Inflation stayed between 1% and 2%
- Central bank accommodation and support
- These resulted in very low interest rates, spreads, and volatility
- In the post-crisis period, risk assets have been outstanding performers
- A winning strategy in this environment has been to stay long interest rates
  - Prior to the last seven weeks:
    - The 10-year Treasury traded around 1.5% to 2% for the past two years
    - High-yield spreads traded as close as ~400 basis points (bps)
    - The MOVE Index showed a consistent downtrend over the last ~18 months

## What has changed?

- The market's perception of future Fed actions
  - Fed support seems less certain
- The Fed has become more optimistic about the economy broadly, and about the labor market specifically
- In its June Federal Open Market Committee (FOMC) statement, the Fed pointed to several parts of an improving backdrop:
  - Diminished downside risks to the economy
  - · Lower unemployment rates in the future
    - » No longer called labor markets weak
    - » Dismissed recent declines in inflation
- These changes came suddenly and were a sharp departure from what we've seen from the Fed
  in the past

- The market is now uncertain about the course of the Fed's asset purchase program and monetary policy
- With this increase in uncertainty, markets have re-priced

# **Market Review**

- Over the course of the last seven weeks, volatility has increased sharply
- Ten-year Treasury rates have backed up to ~2.5%
- High-yield spreads have backed up to ~500 bps
- The US dollar has strengthened, especially versus emerging market currencies
- The market is re-thinking where the federal funds rate will be as we look to the future
  - Eurodollar futures indicate that tightening expectations have been pulled forward
- The last seven weeks have also seen a sharp change in asset class correlations
  - Treasury yields have risen as equity prices have fallen
  - Both high-yield and emerging market bonds have sold off with Treasuries
  - This dynamic has caused asset managers difficulty from a portfolio construction standpoint

#### Outlook

- We don't think a lot has changed underneath the recent volatility
- We believe modest growth in the US will continue at 2% to 2.5%
  - The private sector should continue to improve its balance sheet
  - The housing sector should continue to improve
  - There may be a pick-up in the second half of the year, but there's no sign of it yet
- We think Europe will remain in recession, but it should start to abate toward the end of the year
- We anticipate that China will be moderately softer at 7% to 7.5% GDP
- We believe inflation will remain benign in the short term, but is a concern longer-term
- We expect the Fed to remain accommodative
  - It may start to taper its bond buying program by as early as September, but it will continue to provide supportive monetary policy
  - The federal funds rate is not likely to move before 2015
  - However, some uncertainty over monetary policy will remain

## **Investment Considerations**

- We believe interest rates have largely completed their re-pricing
  - We don't think we're entering a secular bear market in bonds

- Emerging markets (EM) have been substantial underperformers, but we like their fundamentals
  - EM debt and deficit positions are attractive, as are their reserve positions and their growth backdrop
- We're concerned about worsening liquidity positions in the market
  - Is there sufficient risk capital?
  - US primary dealer holdings of corporate bonds greater than one year have decreased dramatically since 2007–2008
  - What happens when we have a liquidating market?

# **Definitions**

**Taper** refers to a gradual reduction in the pace of the Federal Reserve's "Quantitative Easing" bond-buying program.

**Spread** is the difference in yield between two different types of fixed income securities with similar maturities; usually between a Treasury or sovereign security and a non-Treasury or non-sovereign security.

**MOVE Index** refers to the Merrill Lynch Volatility Estimate Index, a yield-curve-weighted index of the normalized implied volatility on 1-month Treasury options for the 2, 5, 10, and 30 year maturities.

**Federal funds rate** is the interest rate that banks with excess reserves at a U.S. Federal Reserve district bank charge other banks that need overnight loans.

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