Fixed Income Outlook

Third Quarter, 2011

Volatility: Accept it Because It Is Likely Here to Stay

The second quarter of 2011 witnessed a complete reversal of the "risk-on" trade which has been so prevalent in credit over the past couple of years. One did not have to search extensively to find areas of concern. The uprisings in North Africa and the Middle East (NAME) and their actual and potential effect on oil prices were just the tip of the iceberg during the period. There were several other areas which concerned the market. However, the largest three of these remaining risks/events were a potential default by Greece, the looming deadline of the federal budget with the question of whether to raise the debt ceiling and employment creation (or lack thereof) with the United States. There were and are so many items to discuss that one could go on almost indefinitely. But when one realizes what these all have in common, it can be summoned up in one word: "Volatility".

Since entering the fixed income business in the early 1990s, I cannot remember a single period with as much volatility as the one we are currently in. Not only is volatility high, but the sources of this volatility comes from various areas of the financial markets. Over the past 20 years, periods of high volatility in the bond market have usually been attributable to one, maybe two, sources. None of these prior periods have been like the current period in terms of volatility composition.

Ironically, the credit market appears to have somewhat subdued fear (with the exception of banks & financial names). Within the investment grade market, new issues came fast and furious during the second quarter. It was generally a period focused on the primary market with secondaries being an afterthought. There were some new investment grade and high yield issuers with names of which we had never heard. However, a noticeable trend in the corporate market was the paring down of inventory held by the broker/dealer desks. This is a sign to us that the sell side may be having difficulty hedging their positions. This is something that we will continue to monitor.

The North Africa/Middle East (NAME) situation, when combined with the price of oil, is the primary risk factor to the fixed income market with potentially significant, long-lasting consequences. A material disruption in supply could lead to much higher oil prices. At a time when the U.S. economy is struggling, an increase in oil prices and their related flow through to finished good prices would likely lead to the dreaded stagflation environment and delay our ability to emerge from our economic malaise and experience real job growth.

The Greece/Euro situation is really an event to watch as it is primarily political in nature. Although it does have consequences for all markets (but most especially for fixed income), it is a problem that will likely be an afterthought in a few weeks for "most" investors. However, this is not a problem that will go away. It will persist so long as the ECB, IMF and other associated parties believe that flooding more money into Greece is the primary way to solve the problem. Until there are material austerity measures implemented in Greece, this problem will arise again when they need more money. One just has to remember that Greece received significant monetary aid just over a year ago, which they spent very quickly without making structural changes to their economy and way of life. Be forewarned, you will hear about Greece again within the next year or two and it will be the same problem.

The U.S. Federal budget and decision to raise the debt ceiling is a real game of chicken among the two political parties. With August 2nd set as the deadline, we hope that some viable solution will be found and implemented. If not, it is uncertain to us what would actually happen to yields of US Treasury securities should the deadline pass without a solution to raise the debt ceiling. There would be an obvious loss of confidence by foreign investors (including central banks) that could cause yields to rise. Alternatively, there could be a massive sell-off in the equity market with the Treasury market being the beneficiary. It is unclear and absolutely impossible to quantify the movement in yields in either scenario. One thing is certain should this occur: academia would have tremendous fodder to write papers in behavioral finance using this situation. Although we have read many research pieces that state there is a zero percent chance of no agreement being reached by August 2nd, we have enough experience to know that stating something is totally impossible in the political realm is quite a naïve stance to take as an investor.

Returning to our theme of volatility, all the above mentioned items (and others) are likely to keep volatility high and erratic for the foreseeable future. Many investment managers abhor volatility. Having been through many market cycles and several "six plus standard deviation" events, we take a different approach to high volatility. Many fail to see that high volatility will often offer tremendous opportunities to add value for the vigilant investment manager. This is our view. We believe that valuations among sectors and securities are likely to fluctuate more than usual. Fluctuating valuations provide an astute investment manager the ability to opportunistically make changes in the composition and characteristics of their portfolios. It takes diligence, vigilance and the ability to act decisively when these opportunities present themselves. As relative value investors, this has always been part of our daily routine. We view volatility as an opportunity- not as an anathema.

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