Corporate Bond Commentary and Strategy – June 2009

Economic indicators are clearly pointing to a slower rate of decline in the economy, led by a consumer that is slowly pulling herself up from the ground and better-than-expected corporate earnings. Pro-active government policy, unprecedented both from the fiscal and monetary perspective, have clearly aided the recent rally and the return of market confidence. The credit markets, after nearly two years of extreme negative performance and volatility, noticed these developments and responded. April and May were the first and second best months, respectively, on record for high-grade credit based on the Barclay's Capital Credit Index returns, and that positive performance has continued thus far in June. To put this move in perspective, the Credit Index has tightened by over 200 basis points since mid-March, more than offsetting the persistent move higher in Treasury rates. As a result, the yield to maturity on the Index has moved from over 7% in mid-March to below 6% in mid-June.

The unknowns

What remains unknown is the sustainability of this rally in the near-term and the impact of the government's policy initiatives further in the future. How will fixed income securities and credit, in particular, perform down the road in an environment of greater regulation and an enormous government deficit? We have already seen a dramatic spike in Treasury yields in recent weeks and the yield curve is at one of its steepest points on record. Is this a reflection of an expected "V" shaped recovery, or of dramatic inflation expectations that could potentially derail the current positive investor sentiment?

Portfolio positioning

While we don't know the answers to these questions, we believe staying relatively short in duration and selective in taking credit risk is the best option. Primarily we are focusing on the single-A and better rated securities in the industrial space, bank obligations for systemically important banks, and short dated, well-researched, but out-of-favor BBB and BB industrial credit. We believe this portfolio structure will allow us to enhance yield while retaining a relatively defensive posture. We believe a portfolio structured in this manner will defend against both an interest rate spike out the curve and will outperform if negative sentiment returns in force in the near-term.

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