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Taxable Fixed Income – Q2 2010 Review

Surveying the taxable bond universe, we find corporate bonds and taxable municipals the most compelling of a relatively lackluster set of alternatives. For the remainder of 2010, we expect interest rates to remain relatively low, although quarter ending levels may be on the lower end of the trading range. Volatility is likely to continue, making active management imperative. We currently favor relatively short-duration securities, including investment-grade and select high-yield corporate securities, callable government agency securities, and taxable municipals. Carefully researched bonds in these market segments can offer yield while avoiding significant interest rate risk.

When the second quarter began, we were concerned that interest rates might rise in the face of robust supply from the U.S. Treasury and the end of significant quantitative easing by the Federal Reserve. Instead, European sovereign debt concerns roiled the market, and the global economic recovery came into question. Looming financial regulatory legislation likewise made investors worry about future bank profitability and consumer and small-business credit growth. Flight to quality was the result, and Treasury securities were the best-performing asset class in the capital markets.

In the last quarter, yields on US Treasury notes and bonds fell across the maturity spectrum, with 7- and 10-year notes showing the largest declines (0.86% and 0.89%, respectively). Fears of inflation in the U.S. subsided, in both the short and the medium term: The inflation premium built into the yields of 10-year Treasury Inflation Protected Securities (TIPS) dropped 42 basis points, bringing inflation expectations to 1.84% over the life of the bond. The differential between the 2-year and the 10-year Treasuries also eased by 48 basis points, further evidence of investor doubts about future growth and inflation.

Corporate bond yields fell in the quarter, too: The yield on the Barclays U.S. Credit Index declined by 26 basis points, to close at 4.03%, near the record low levels of 3.9% in May of 2003. Nonetheless, corporate bonds underperformed Treasuries for the first time since Q1 2009. The spread between the average Investment Grade corporate bond and U.S. Treasuries increased by 43 bps during the quarter to 179 basis points, implying a higher level of risk aversion. Mitigating these risks to some extent are the record cash on hand and relatively robust corporate earnings that support already strong balance sheets.

Spreads on taxable municipals appear attractive relative to similarly rated corporate bonds, although that increase in spread comes with a decrease in liquidity. We see potential for spread compression from here for both sectors, but the low absolute yields resulting from historically low Treasury yields will limit upside. The spreads for Mortgage-Backed Securities and Government Agencies over Treasuries remain extremely low and have even less relative upside potential.