bond market review & outlook

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fourth quarter
2011

OUTLOOK

Central banks around the world began to provide more liquidity to the capital markets in the fourth quarter, and risk-oriented assets rejoiced. It was a very good quarter for equities, corporate credit and high yield bonds. However, the all-clear signal has not been given, as the sovereign debt crisis in Europe remains unresolved and signs of a slowdown in China continue to accumulate.

Some significant central bank policy actions during the fourth quarter included:

- Coordinated efforts by the US, Canada, Britain, Japan, Switzerland and Europe to ease the global liquidity crunch by lowering the cost of existing dollar swap lines by 50 basis points and arranging bilateral swaps to provide liquidity for other currencies;
- China's move to cut its bank reserve requirements;
- The European Central Bank's decision to cut rates by 50 basis points to 1.0% and its provision of three-year loans to banks;
- The Bank of England's announcement of another round of quantitative easing;
- The International Monetary Fund's decision to grant Greece another tranche of its emergency loan program;
- Interest-rate cuts by central banks in Australia, Sweden and Brazil.

These actions were certainly welcome, and markets responded by posting remarkable returns for the fourth quarter. However, the European economy may be slipping into recession, which should make it much harder to implement fiscal austerity, reduce budget deficits and convince investors that debt ratios will eventually stabilize.

The negative feedback loop from weak sovereign credit metrics to weak bank balance sheets will likely continue to be a source of risk in 2012. To comply with new European Banking Authority requirements that take effect June 2012, banks must increase their capitalization ratios and can do so by raising equity, shrinking assets, or cutting staff, bonuses and dividends to retain more earnings. As such, there is evidence that European banks are restricting credit, shrinking their balance sheets and reducing staff to meet tougher capitalization standards. Ultimately, we see these actions reinforcing the negative feedback loop between sovereign credit and bank balance sheets.

We expect the deflationary pressures from Europe and the hangover from the financial crisis to remain intense during 2012, which should keep high-quality bond yields very low around the world. Cooling emerging market economies, principally China, Brazil and India, have also contributed to lower global bond yields. Commodity price pressures have eased, which should help reduce inflation and allow for more central bank rate cuts around the world.

In this enduring environment of zero policy rates and low yields on high-quality bonds, we believe the global search for yield will remain a key theme in 2012. This environment suggests bonds across the quality spectrum trading at a premium to government bonds could achieve respectable risk-adjusted returns. With that in mind, we favor US high yield bonds, bank loans and investment grade credits.

FOURTH QUARTER REVIEW

RETURNS BY SECTOR *as of December 31, 2011*[1]

INDEX	1 MO.	3 MO.	6 MO.	12 MO.	4Q COMMENTARY
US Broad Market					Bond yields moved sideways-to-lower in the final quarter of the year, after experiencing much sharper declines earlier in 2011. Stocks surged in the quarter but the move was not enough to overcome the rally in bonds for 2011. Full year total returns for bonds were 7.84% versus just 2.11% for equities.
Aggregate Index	1.10	1.12	4.98	7.84	
Government/Credit Index	1.29	1.18	5.98	8.74	
S&P 500 Index	1.02	11.82	(3.69)	2.11	
US Governments					2011 was a year of macro themes and events that challenged performance in riskier assets but led to strong gains in relative safe havens like US Treasurys. Treasury yields drifted lower in the first half of the year, with the 10-year Treasury yield falling from ~3.50% to ~3.00%. During that time, Japan's economy was hit by the earthquake/tsunami and the Arab Spring caused oil prices to spike. Economic growth in the US was sluggish but expected to turn up in the second half of 2011, hence the modest move in bond yields. However, as the situation in Europe deteriorated, investors began to question the survival of the euro and worried about global growth. Despite acrimonious debt ceiling negotiations and a debt downgrade in the US, Treasurys became the investment of choice. The 10-year yield plunged about 100 basis points in the third quarter and held on through the fourth quarter, to end the year almost 150 basis points lower, earning a total return of 17.18%.
US Treasurys	0.97	0.89	7.43	9.81	
3-month T-bills	0.00	0.00	0.02	0.11	
2-year Treasury	0.04	0.09	0.60	1.53	
5-year Treasury	0.77	1.26	5.88	9.36	
10-year Treasury	1.96	1.23	13.54	17.18	
30-year Treasury	3.75	1.95	33.62	35.60	
US TIPS	0.04	2.69	7.32	13.56	
US Agency	0.43	0.55	3.05	4.82	
US Municipals	1.90	2.12	6.02	10.70	Municipals finished out the year with supply remaining constrained but demand, as measured by net fund flows, improving. With credit generally better than expected for the year, despite a couple of high profile bankruptcy filings, municipals proved to be an investment of relative stability and performance in 2011.
US Securitized					CMBS performed well in the fourth quarter, particularly in December when developments in Europe modestly eased fears on riskier assets. ABS had decent returns in the quarter while full year performance benefited from the sector's perception as a relative safe haven from its mostly stable cash flow and credit dynamics. High prices and prepayment uncertainty due to government programs weighed on MBS in 2011, somewhat dampening results.
MBS: Mortgage-Backed	0.70	0.88	3.26	6.23	
ABS: Asset-Backed	0.13	0.23	2.66	5.14	
CMBS: Commercial Mortgages	1.31	3.11	2.22	6.02	
Corporates US Investment Grade	2.14	1.93	4.83	8.15	In absolute terms, corporates returned just over 8% in 2011, not far from the 9% gain in 2010. Relative to duration matched Treasurys, however, corporate performance (as measured by the Index) disappointed. The spread on the Index moved from roughly 150 basis points in the H1:2011 to 250 basis points in early October when "risk off" fears were strongest. Spreads narrowed to 234 basis points by year-end. Financials were particularly hard hit all year on concerns over European banks. Industrials and utilities did better, particularly technology and capital goods.
AAA	2.09	1.12	9.87	12.33	
AA	2.02	1.73	4.72	7.07	
A	2.06	1.63	4.56	7.68	
BBB	2.28	2.40	5.04	9.05	
Corporates European Investment Grade *(local currency returns)*	2.58	1.34	(0.01)	1.49	In the third quarter of 2011, growing concerns over the European situation and fears over global growth significantly detracted from returns in the corporate market, especially for BBBs and single-As. The fourth quarter saw continued volatility as progress in Europe came in fits and starts. Still, it was enough for corporates to recover some lost ground. BBBs ended the year at a loss but single-As eked out a gain of 1.21%. Across the channel, sterling corporates were much stronger, though returns still lagged the US market.
AAA	3.18	1.22	5.92	6.97	
AA	2.38	1.79	2.58	3.81	
A	2.70	1.13	(0.18)	1.21	
BBB	2.52	1.63	(2.43)	(0.43)	
Sterling Investment Grade	2.64	3.32	3.00	6.52	

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Corporates US High Yield	2.66	6.46	0.01	4.98	Macro concerns overwhelmed micro strength in the third quarter, causing high yield to plunge 6.06%. Fast forward to the fourth quarter and high yield gained 6.46%. Despite poor market liquidity, high yield turned up as consensus views moved toward slow growth/no recession in the US. It was a nice finish to a tough year. Still, with a gain of just 4.98% for 2011, results were disappointing relative to the risk.
BB	2.39	5.61	1.70	6.84	
B	2.63	6.40	0.84	5.39	
CCC	3.31	8.42	(4.30)	1.18	
Corporates Pan-Euro High Yield *(local currency returns)*	3.39	4.67	(5.87)	(2.39)	Returns for European high yield were positive for the quarter, after falling by double digits in the previous quarter. Most sectors within the market gained 3% to 6%, with technology (down 2.7%) the outlier. For the year, there was a wide dispersion of performance by sector, with financials down 7.4%, industrials down 1.8%, and utilities up 6.0%. Energy was the only other industry to post a positive return in 2011 at 2.4%.
BB	3.42	4.70	(3.09)	(0.15)	
B	2.81	4.81	(6.36)	(3.67)	
CCC	4.61	4.53	(22.56)	(14.17)	
Bank Loans US High Yield	0.47	3.08	(1.45)	1.06	Banks loans are often referred to as "high yield light." The two sectors tend to move in the same direction but by different magnitudes. High yield loans sold off less than bonds in the third quarter and then rallied less in the fourth quarter. For the year, BBs were the sweet spot of the loan market, gaining 2.44% while the riskier CCC bucket lost 8.89%.
BB	0.56	3.14	0.88	2.44	
B	0.85	3.48	(1.31)	1.92	
CCC	(1.14)	1.22	(12.19)	(8.89)	
Developed Countries World Government Bond Index *(local currency returns)*	1.73	0.68	4.69	5.74	In the fourth quarter, US Treasurys gained 0.89%, outpacing Japan at 0.46% and Europe at -0.43%. Within Europe, the "PIIG" (Portugal, Ireland, Italy, and Greece) posted poor results, along with France. Germany did relatively well as it continued to benefit as the perceived safe haven in the region. The yield on 10-year bunds fell 6 basis points in the fourth quarter while, in comparison, the yield on 10-year Italian bonds rose over 150 basis points. However, the best performance in the Index came from the UK at 5.46%, followed by New Zealand and Australia at 3.76% and 3.45%, respectively. For the full year, US, Canada and Germany were up over 9%. Best performers included the UK, New Zealand, Australia and Ireland, with other European peripherals bringing up the rear. Investors were apparently attracted to the UK gilt market by its high credit quality ratings and its contrasts with the euro bond markets (the UK has its own currency and monetary policy, two features looking particularly attractive given the trouble the euro zone is having in dealing with its sovereign debt crisis).
Non-USD WGBI	2.04	0.63	3.80	4.40	
United States	0.92	0.83	7.31	9.61	
Canada	1.13	1.65	7.59	9.54	
European GBI	4.01	(0.43)	3.41	3.41	
France	2.15	(1.46)	4.66	4.59	
Germany	3.08	1.88	9.81	9.60	
Greece	(11.82)	(37.37)	(53.21)	(60.01)	
Ireland	5.40	(1.58)	25.65	11.54	
Italy	5.17	(3.03)	(7.21)	(5.73)	
Portugal	4.41	(3.68)	(4.59)	(22.40)	
Spain	7.23	1.81	4.45	7.29	
United Kingdom	1.73	5.46	14.93	16.90	
Japan	0.66	0.46	1.61	2.20	
Australia	1.05	3.45	9.46	14.26	
New Zealand	1.12	3.76	7.95	14.71	

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Currency Markets				
Dollar Bloc				
Canadian Dollar	(0.38)	2.84	(5.67)	(2.28)
Australian Dollar	(0.72)	5.66	(4.78)	(0.23)
New Zealand Dollar	(0.42)	2.08	(6.27)	(0.38)
Western Europe				
Euro	(3.61)	(3.18)	(10.63)	(3.16)
Norwegian Krone	(3.42)	(1.83)	(9.84)	(2.57)
Swedish Krona	(1.80)	(0.19)	(8.11)	(2.55)
Swiss Franc	(2.65)	(3.19)	(10.41)	(0.31)
UK Pound	(1.03)	(0.26)	(3.18)	(0.44)
Emerging Europe				
Czech Koruna	(4.72)	(6.61)	(14.96)	(5.31)
Hungarian Forint	(7.05)	(9.83)	(24.50)	(14.35)
Polish Zloty	(2.77)	(4.17)	(20.40)	(14.02)
Russian Ruble	(4.47)	0.15	(13.28)	(4.98)
Turkish New Lira	(3.32)	(1.64)	(14.17)	(18.35)
Asia				
Japanese Yen	0.92	0.20	4.75	5.47
Chinese Renminbi	1.34	1.37	2.68	4.96
Indonesian Rupiah	0.49	(1.31)	(5.40)	(0.80)
Malaysian Ringgit	0.31	0.66	(4.68)	(3.30)
Singapore Dollar	(1.16)	0.83	(5.25)	(1.02)
South Korean Won	(0.86)	2.23	(7.36)	(2.30)
Latin America				
Argentine Peso	(0.46)	(2.21)	(4.45)	(7.47)
Brazilian Real	(3.12)	0.66	(16.26)	(11.01)
Chilean Peso	(0.73)	0.04	(10.07)	(9.92)
Colombian Peso	0.62	(0.34)	(8.65)	(1.59)
Mexican Peso	(2.23)	(0.28)	(15.95)	(11.45)
Peruvian New Sol	0.32	2.82	1.99	4.08
Emerging Market Government (EMBIG) *(USD returns)*	1.17	5.12	3.21	8.46
Corporate Emerging Market Bond (CEMBI) *(USD returns)*	1.12	5.45	N/A	3.49
Emerging Market Government (GBI-EM) *(local currency)*	0.05	1.42	3.50	6.44

4Q COMMENTARY

The euro (EUR) fell 3.2% for the quarter and the year. The surprise is that it didn't fall more given the severity of the sovereign debt crisis in the region. The currency appears to have held up relatively well earlier in the year on buying by central banks (diversifying away from the US dollar) and by European banks. In the fourth quarter, the EUR fell as investors grew increasingly worried about the future of the currency and whether all members would remain committed to it. Emerging Europe currencies were among the worst performers for the quarter and the year. Investor concerns have risen over Hungary's financial situation, as evidenced by sharply wider CDS spreads for the sovereign.

The Japanese yen (JPY) gained just 0.20% in the fourth quarter but rose 5.47% for the year, making it one of the best performers in the currency market. This gain came despite three separate efforts by the Bank of Japan to intervene in the market and keep the currency from strengthening too much. Tokyo was concerned that a strong yen was the last thing the country needed as it was recovering from the earthquake and nuclear crisis of the spring. Like the JPY, the Chinese renminbi (CNY) also rose 4.96% against the US dollar. Unlike Tokyo, however, Bejing did not fight the move as they wanted to rein in growth due to inflation fears and concerns over a potential property bubble.

Latin American currencies had mixed performance; with the two key markets of Brazil (BRL) and Mexico (MXN) both off 11% or more for the year. Global growth worries hurt BRL returns in H2:2011. MXN typically moves with concerns over US manufacturing but can also suffer when investors are in a risk off mood, as it tends to be one of the most liquid EM currencies.

Emerging market corporates (CEMBI) performed well in the fourth quarter, in line with US corporate markets. However, the 3.49% return for the year lagged behind the sovereign return of 8.46% (EMBIG) and local currency (GBI-EM) gain of 6.44%. For much of the year, EM debt markets held up while other risk assets sold off. Investors were attracted to the generally higher growth and higher yields available. However, as global growth fears escalated in the third quarter, investors appeared to take down risk by selling the sector that had held up. Within EM, Latin America performed best for the quarter and the year while the European region lagged behind (also for both periods).

[1] *All returns sourced from Barclays Capital Indices except: World Government Bond (Citigroup), Emerging Market Bond (JPMorganChase), and S&P 500 (FactSet and Ned Davis Research).*

Barclays Capital US Aggregate Bond Index: *an index of investment grade bonds with one- to ten-year maturities issued by the US government, its agencies and US corporations.* ***Barclays Capital US Government/Credit Bond Index:*** *includes Treasurys (public obligations of the US Treasury that have remaining maturities of more than one year) and agencies (publicly issued debt of US government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the US government) as well as other publicly issued investment grade corporate and non-corporate debentures that meet specified maturity, liquidity, and quality requirements.* ***S&P 500 Index:*** *a capitalization-weighted Index of 500 common stocks chosen for market size, liquidity, and industry group representation to measure broad US equity performance.* ***Citigroup World Government Bond Index:*** *represents the broad global fixed income markets and includes debt issues of US and most developed international governments, government entities and supranationals.* ***JP Morgan Emerging Markets Bond Index Global (EMBIG):*** *tracks total returns for traded external debt instruments in the emerging markets including US dollar-denominated Brady bonds, loans and Eurobonds.* ***JP Morgan Corporate Emerging Markets Bond Index (CEMBI):*** *tracks US-dollar denominated debt issued by emerging market corporations.* ***JP Morgan Government Bond Index-Emerging Markets (GBI-EM):*** *tracks local currency bonds issued by emerging market governments.*

All indexes are unmanaged, do not incur fees and it is not possible to invest directly in an index.

Past performance is no guarantee of future results.

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