

F.I.R.S.T. Fixed Income Research and Strategy Trends

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2008: Good Riddance

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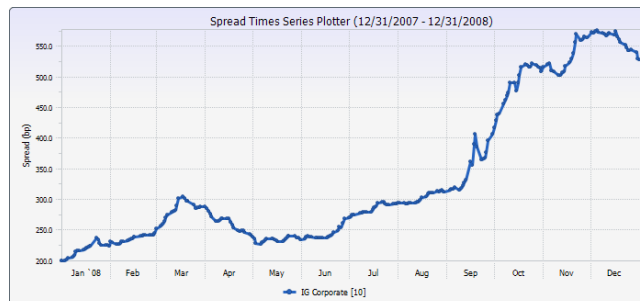
It's an old cliché that what doesn't kill you makes you stronger. We got through that mess! Now for the spoils! While portfolio managers are congenitally biased to be bullish on their own sectors, please grant me a bit of forbearance as I point out some opportunities. 2009 is likely to be very different sort of experience. While we are not out of the woods yet, for those with any money left, here are a few ideas we expect to become compelling:

Corporate bonds are screaming cheap and priced for economic oblivion. Indeed, the sluggish timetable for an economic revival will test much of the credit market in coming months. Choose individual bonds with care. Yet, for long term investors, the risk/reward profile is attractive with eight and nine percent investment grade yields.

Government backed paper offers valuable arbitrage opportunities. Treasuries have obviously done very well. They provided excellent performance in 2008 and may still be a safe harbor. The risk is that regular buyers may deploy additional investing elsewhere. Foreign buyers may revert to home country investments. They, along with others may search for more yield. Options can include Fannie Mae and Freddie Mac debt, Agency MBS and FDIC-guaranteed issues from major financials, all of which provide more yield. While the markets are a bit two faced about the explicitness of some of the government support and the liquidity is not the same as Treasuries, these are very much Uncle Sam in drag.

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Credit spreads on ten year investment grade bonds have started to narrow. - Data from Barclay's Capital

Merger Arbitrage is available to "long only" portfolios. As financial firms' balance sheets contract, hedge funds unwind and financing becomes difficult to source, trades that were historically arbitrated much further up the food chain present themselves to investment portfolios. Merrill and Countrywide bonds are cheap compared to Bank of America, which is the same entity. Golden West and Wachovia paper is likewise cheap compared to Wells Fargo. The list goes on.

Municipal bonds were hit with a perfect storm in 2008. The crumbling of the insurance back-up providers, the significant cut back in dealer community support for the secondary markets and fears over the outlook for state and local budgets. With these factors still in play, Munis remain very cheap. However, pick credits carefully for ten year after tax yields 2.5+ times that of ten year Treasuries.

Our macro themes for the coming months include examining several unresolved tensions. First is the difficulty finding a sense of value inside volatile markets. Low rates on Treasuries give pause, and yet late December auctions went well. Both fear and balance sheet dressing-up were strong forces, though near-zero yields challenge valuation metrics. 2009 will either be a bright year for returns on risk again, or volatility will remain a more persistent theme for investors. A related issue reflects on if we now have a cash bubble and, if so, where this cash eventually goes.

Second, while the Fed has begun to fight deflation, and many around the world fear a Japan-like “lost decade” in the U.S., others worry that bountiful Fed-manufactured liquidity, and the result of the current cash bubble, will lead to a risk of “Weimar Republic” reflation. An associated issue relates to the Fed flooding the market with funding. This is a quantitative easing process that aims to supply the banking system with liquidity rather than targeting an interest rate. While the banks survive and get flush with cash in order to continue to shed distress assets and unwind their leveraged positions; the credit crisis still has many that need funding without access or with onerous conditions. Contracting these credit spreads is important to economic growth.

Third, perhaps the biggest casualty of 2008 is the loss of confidence by investors of all categories. The Madoff scandal was significant. So was the washout of the hedge fund industry. These players will shrink by more than half. Their leverage will shift from something north of 10:1 to more like 2:1 or 3:1. Trillions of dollars will continue to unwind as risk-takers face liquidation. This could mean the near-term and dominant investment themes will continue to be macro-driven, leaving much of the traditional professional investor strengths of value investing and bottom-up analysis by the wayside. ■