

Trends to Watch in the New Decade

Emerging Investment Themes for Corporate Cash Investors

Investment Considerations:

- *We think there may be a shorter than expected timetable for Fed rate hikes and that it may be prudent to keep a portfolio of shorter maturity bonds and floating rate securities. This strategy also applies to money market funds with shorter weighted average maturities (WAMs).*
- *We believe yield levels may rise causing the yield curve to steepen even with the Fed on hold. Yield opportunities in 2010 may be more attractive than in 2009 as the year wears on.*
- *Elevated concerns over the solidarity of the European Union may increase market volatility and systemic risk. We believe limiting credit exposure to the highest-rated sovereign entities and staying liquid in portfolios is well advised.*
- *Lower private debt issuance and strong demand should keep credit investments attractive in 2010. We will look to add debt from economically sensitive sectors as the economy strengthens further.*

Published: January 4, 2010

Lance Pan, CFA
Director of Investment Research
Main: 617.630.8100
Research: 617.244.3488
lpan@capitaladvisors.com

Trends to Watch in the New Decade

Emerging Investment Themes for Corporate Cash Investors

WHAT A DIFFERENCE A YEAR MAKES

During this time last year, as Treasury securities offered negative yields and credit risk was in full throttle, we cautioned cash investors to beware of the “bear trap” of higher Treasury yields and be patient before moving into financial credits. As the year wore on, we saw improved capital market conditions, stronger bank capitalization and a positive turn in the economy. We subsequently shifted our investment strategies to include industrial credits and a select group of systemically important financial institutions and prime money market funds.

At the start of the “teens” decade, we are now faced with a new investment landscape, much of which is the result of globally coordinated efforts to bring economies and markets back from the abyss. As credit investors, we are constantly on the lookout for hotspots that may present risk to the prudent cash investor. Here, we discuss four emerging investment themes and share our thoughts on how to manage them.

1. THE FED MAY NEED TO HIKE RATES SOONER THAN LATER

The December 2009 Federal Open Market Committee (FOMC) meeting concluded with a statement that the central bank would keep its key interest-rate target between 0% and 0.25% for an “extended period.” Economic and market news in recent weeks, however, suggests that an upbeat financial outlook may force the Fed’s hand to hike rates sooner than planned. Several Wall Street firms recently revised their estimates for the fourth quarter 2009 GDP to as high as 4.5%.¹ If growth continues at a healthy clip, it will become increasingly more difficult for the Fed to keep interest rates at these record lows for long before stoking inflation.

While there has been talk that the high unemployment rate and the so-called GDP output gap will keep inflation low, history shows that unemployment often is a lagging indication for inflation, not a leading one. For example, the core consumer-price index (CPI) in 1984 went up 5%, while unemployment hovered above 7%.² The use of the output gap between potential and actual GDP to gauge inflation often is criticized as an unreliable predictor in the real world.³

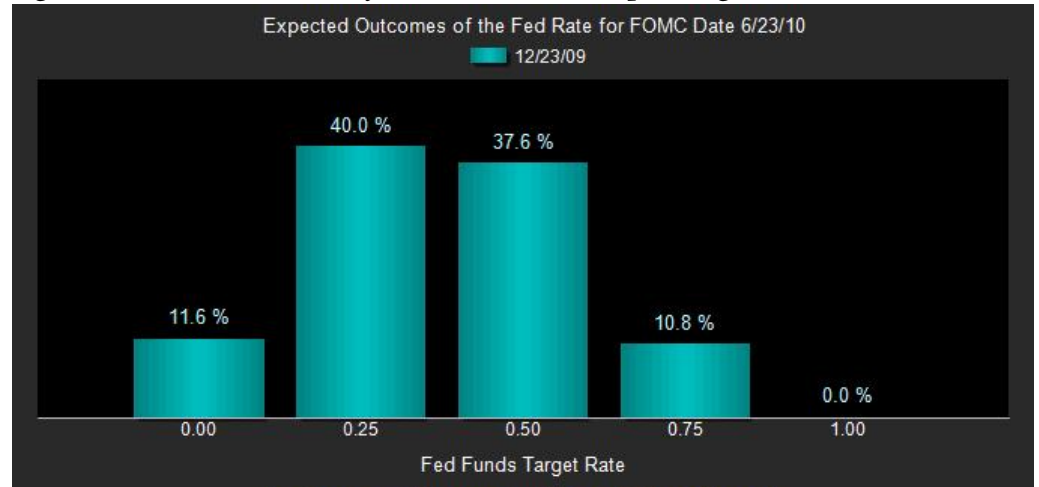
Published: January 4, 2010

Lance Pan, CFA
Director of Investment Research
Main: 617.630.8100
Research: 617.244.3488
lpan@capitaladvisors.com

On December 1, 2009, Federal Reserve Bank of Philadelphia President Charles Plosser, reiterated his position that the Fed should act preemptively to keep inflation expectations well-anchored, including hiking rates even before unemployment or

other measures of resource slack diminish.⁴ Indeed, recent futures market indications project the probable start of the rate hikes to occur in mid-2010.⁵

Figure 1: Futures Indication of Fed Fund Rates at Upcoming FOMC Dates



Note: These probabilities were calculated using Fed Funds futures data.

(Source: Bloomberg screenshot. The probability of the Fed funds rate at .50% or .75% at the 6/23/10 meeting was 47% as of December 23, 2009)

Historically, the Fed’s own assessment of when to move on rates sometimes turned out to be an embarrassment. As the long-time Fed watcher Caroline Baum points out, the FOMC statement on August 7, 2007 mentioned inflation as the “predominant policy concern.” Ten days later, the Fed lowered the discount rate by 0.50% with a statement saying the “downside risks to growth have increased appreciably.”⁶ The bottom-line is that the Fed is a creature of economic circumstances. It must sometimes react forcefully as the situation on the ground changes.

Key thought: When there is a shorter timetable for Fed rate hikes, it pays to keep a portfolio of shorter maturity bonds and floating rate securities. The strategy also applies to money market funds with shorter weighted average maturities (WAMs).

2. BOND YIELDS MAY RISE, RESULTING IN A STEEPER YIELD CURVE

Another result of the credit crisis is the more than \$1 trillion in emergency liquidity the Fed pumped into the banking system. We believe the Fed’s move to drain this liquidity will result in higher yield levels due to market expectations, regardless of whether it actually raises the policy rate. If the overnight yield is anchored at near-

zero levels, we should expect the money market yield curve to become steeper as yields rise faster further up on the curve.

As of December 16, 2009, the Fed held \$776 billion in U.S. Treasury securities, \$157 billion in Federal agency debt, \$901 billion in agency mortgage-backed securities and roughly \$100 billion in other emergency liquidity facilities expiring in the first half of 2010.⁷ As the Fed releases this government bond inventory to the open market, we expect bond yields will rise due to increased supply.

Another factor that could lead to a higher yield environment is the expected heavy government debt issuance. The Congressional Budget Office puts the official federal budget deficit and new federal debt in 2010 at \$1.4 trillion.⁸ The combined \$3.2 trillion government debt from the Treasury and the Federal Reserve, though not likely to be dumped in all at one time, may push yields up significantly in 2010.

In addition, issuers previously benefitting from Treasury and Fed support programs may need to pay more money to access the short-term market. Although most of the facilities were not heavily utilized in recent months, in our opinion, their very existence was an insurance mechanism to keep yields low. With the expiration of the government programs, we expect corporate and financial borrowers to pay incrementally higher yields to avoid being crowded out by the government debt. (We will discuss the counterbalancing factor in credit spreads later.)

***Key Thought:** Since we expect yield levels to rise and the yield curve to steepen, we believe staying defensive and keeping maturities shorter is well advised. Yield opportunities may be more attractive than in 2009 as the year wears on.*

3. SOVEREIGN CREDIT RISK IS A TREND TO WATCH

The result of unconventional government interventions worldwide to revive markets and economies is the soaring debt burden in many developed countries. While 2009 already was bubbling with sovereign debt concerns, 2010 may turn out to be even more challenging when investor concerns shift from the peripheral countries (For example, Portugal, Italy, Ireland, Greece and Spain) to the leading pack of the U.S., the U.K., France and Germany.

Sovereign credit risk may be closer to home than an unsuspecting cash investor might think. Various government guarantee programs for bank debt to prop up fragile markets resulted in many prime money funds and separate account cash investors

swapping their bank credit risk exposures for those of the sovereign support entities. Developed countries such as France, Germany, Ireland, Sweden, and Luxemburg rushed to the U.S. market in issuing dollar-denominated short-term debt. In our November 2009 newsletter, we noted the increased exposure of the largest U.S.-based prime money funds to sovereign credits.⁹

We take a keen interest in this area because the current debate on the European Union rescuing its weaker members may become more intense as the stronger nations face more fiscal and debt challenges of their own. Coincidentally, as Ireland emerged from recession – its economy grew 0.3% in the third quarter of 2009 – the U.K.’s GDP contracted 0.2% in the same period.¹⁰ Hints of credit ratings downgrades from the AAA status have pointed to not only the U.K., but also the U.S. and France in recent reports. For example, the recent €80 billion French “special national bond” was mentioned as an indication of how AAA-rated countries increased borrowing as disguises for follow-up stimulus plans.¹¹ In the U.S. 40 states are expected to run out of unemployment benefits funding and be forced to borrow \$90 billion from the federal government to close the gap.¹²

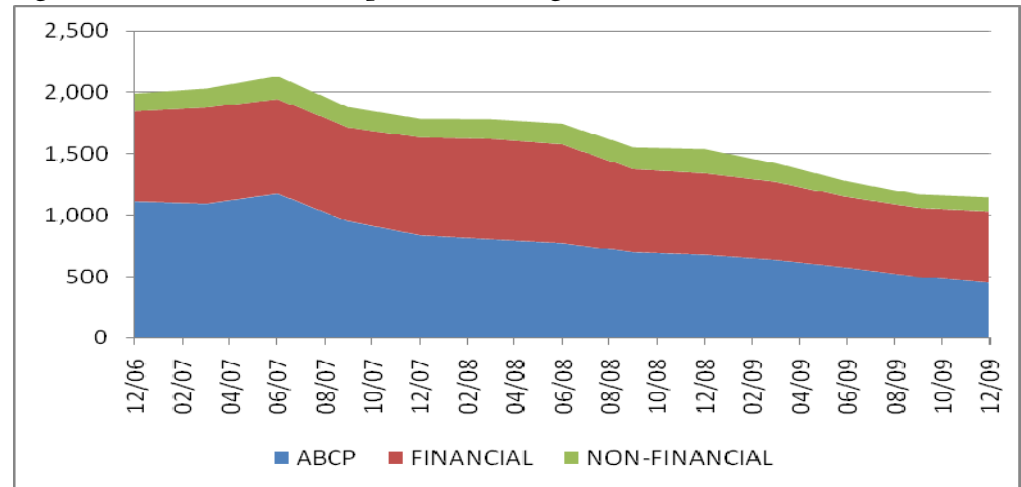
Of course, losing AAA ratings is a long way from any measurable increase in default risk. However, we expect increased market volatility as the number of EU members needing support increases and the talk of the break-up of the Euro currency heats up.

***Key Thought:** Elevated concerns with the solidarity of the European Union may increase market volatility and systemic risk. We would limit our credit exposure to the highest-rated sovereign entities and stay liquid in our portfolios.*

4. SPREADS SHOULD REMAIN TIGHT AS SUPPLIES DIMINISH

In contrast to higher government debt issuance and bond yields, we expect private short-term debt issuance to decrease in 2010, leaving credit spreads to Treasuries well supported in the short-term part of the yield curve. In other words, we see this year as the continuation of the recent balance sheet deleveraging trends in households, businesses, and financial institutions.

Figure 2: U.S. Commercial Paper Outstanding



(Source: The Federal Reserve’s website. Commercial Paper Outstanding, data as of December 23, 2009)

Figure 2 shows that after rising briefly to about the \$2 trillion mark in mid 2007, commercial paper outstanding in the U.S. declined in nine of the last 10 quarters. Most noticeable is the asset-backed commercial paper market, which saw its size shrink by 62%. Financial CP outstanding dropped 24.9%, and non-financial CP dropped 39.3%.

Due to lingering credit concerns and the prevailing low yield environment, we expect banks to hold on to their deposits in 2010, reducing the need to tap the financial CP market. Lackluster demand for consumer credit and regulatory changes will likely also keep the lid on the growth of ABCP outstanding. Volume of non-financial CP may increase as economic activities pick up and businesses stock up on inventories, but overall CP supply is unlikely to change materially from 2009.

Meanwhile, demand for investment grade short-term debt should remain solid. The low interest rate environment likely will continue to anchor investors’ interest in earning a spread over government securities. The recent credit crisis and the upcoming banking reforms already resulted in banks increasing high grade short-term investments on their balance sheets to improve liquidity.

Key Thought: Lower private debt issuance and strong demand should keep credit investments attractive in 2010. We will look to add debt from economically sensitive sectors as the economy strengthens further.

CONCLUSION: SHIFTING FOCUS

As we polish our crystal ball for 2010, we foresee a shift of our attention from credit to bond yield. We think the year will be no less challenging for the Fed than in recent years past as it juggles to balance the removal of excess liquidity without stifling growth or stoking inflation. We expect short-term bond yields to increase as a result of large government debt offerings and concerns with sovereign credit around the world. By contrast, we are more constructive on yield spreads of non-sovereign credit investments due to diminishing supply and solid investor demand.

¹ Scott Patterson, “Why a Rate Increase Could Happen Sooner Rather Than Later”, *The Wall Street Journal*, December 21, 2009.

² IBID

³ Caroline Baum, “Inflation Doves Put Faith in Output-Gap Region”, Bloomberg Commentary, April 17, 2009; Vivien Lou & Scott Lanman, Mishkin Says Output Gap May Give Wrong Inflation Sign, Bloomberg, May 24, 2007.

⁴ Michael Casey, “Philly Fed’s Plosser Calls for Rate Increases Sooner Rather Than Later”, *The Wall Street Journal*, December 1, 2009.

⁵ According to the Bloomberg FFIP screen of Fed funds futures as of December 23, 2009.

⁶ Caroline Baum, “Fed’s Road to Neutral Is Riddled with Potholes”, *Bloomberg Column*, December 14, 2009.

⁷ H.4.1 Factors Affecting Reserve Balances, Federal Reserve website, Release Date: December 17, 2009.

⁸ The Budget and Economic Outlook: An Update, Congressional Budget Office, August 25, 2009.

⁹ Lance Pan, “How Safe are Prime Money Market Funds? And Are All Funds the same?”, Capital Advisors Group, November 1, 2009.

¹⁰ Jane Wardell, UK Economy shrank 0.2% in Q3, *The Associated Press*, December 22, 2009; Charlie Taylor, Ireland technically out of recession, *Irish Times*, December 17, 2009.

¹¹ Ambrose Evans-Pritchard, “France’s Special Bond Raises Doubts over AAA Rating”, *The Telegraph*, July 14, 2009.

¹² Peter Whoriskey, States’ jobless funds are being drained in recession, *The Washington Post*, December 22, 2009.

The information contained in this report has been prepared by Capital Advisors Group, Inc. ("CAG") from outside sources, which we believe to be reliable; however, we make no representations, express or implied, as to its accuracy or completeness. Opinions expressed herein are subject to change without notice and do not necessarily take into account the particular investment objectives, financial situations, or particular needs of all investors. This report is intended for informational purposes only and should not be construed as a solicitation or offer with respect to the purchase or sale of any security. CAG is under no obligation to make changes or updates to this report and therefore disclaims any liability should the information or opinions contained herein change or subsequently become inaccurate. Past performance is no guarantee of future results.

© 2009 Capital Advisors Group, Inc. All rights reserved. This report may not be reproduced or distributed without CAG's prior written consent.