



Bonds Could Maintain Rally as End of Fed's 'QE2', Debt Ceiling Deadline Draw Near

While the economy has shown signs of losing momentum in recent months, continued improvement in the labor market and robust corporate earnings can hopefully overcome weather, the rise in oil prices, and Japan's impacts, in order to limit the current soft patch to a temporary pause. As the year progresses, market participants will be closely watching the direction of interest rates after the Federal Reserve (Fed) ends its bond-buying program in June that was aimed at preventing deflation and expanding credit.

Even with its more than \$14 trillion in debt outstanding, on April 18, Standard & Poor's affirmed its AAA rating for U.S. sovereign debt, but downgraded its long-term U.S. outlook from stable to negative. The rating agency pointed out that the debt reduction plans put forth recently by both political parties were too far apart to be credible, and that unless an agreement is reached by 2013, the U.S. fiscal condition would be "meaningfully weaker" than that of other AAA-rated nations. While the initial market reaction was negative for U.S. Treasury prices, sending yields higher, Treasuries ended the day higher, as the downgrade by S&P was viewed more as a "shot across the bow" that could potentially bring action from lawmakers more quickly than previously believed.

While we continue to hold an underweight to Treasuries, focusing on shorter-duration government agency debt as a hedge against unforeseen market events, including the termination of the Fed's second large asset purchase program, commonly known as quantitative easing, or QE2, market participants have differing views on how the end of the Fed program will impact bond yields. Bill Gross, founder, managing director and co-Chief Investment Officer of PIMCO, who oversees \$1.2 trillion in assets, has gone on the record that the absence of such a large buyer means Treasury prices are likely to fall, pushing yields higher. Rick Rieder, CIO of fundamental fixed income at BlackRock, who manages more than \$1.5 trillion in fixed-income assets, takes the other side, and believes that as markets have known for several months that QE2 will end it has had plenty of time to prepare. As such, Rieder has been buying bonds as he believes the actual end of QE2 will have little effect on yields.

Historically yields have risen with the implementation of asset purchase programs and contracted when the plans are terminated. On the enclosed graphs, Jeff deGraaf, CMT, CFA of Renaissance Macro Research highlights that Treasury yields moved up after the Fed initiated its first large asset purchase program in late 2008 and then fell after the plan's conclusion in March 2010. Bonds markets in both the U.K. and Japan have experienced similar reactions.

Moreover, the focus on fiscal austerity in Washington as the deadline to raise the debt ceiling approaches could be an additional positive for bonds. Greg Valliere, Chief Political Strategist at the Potomac Research Institute recently pointed out that while it seemed at the beginning of the year that everyone was predicting interest rates going straight up, as long as austerity is the "byword" in Washington, the much feared rise of interest rates may not occur. Jeffrey Gundlach, of DoubleLine in Los Angeles, the top-performing bond manager of the past decade, concurs. He believes that lawmakers in Washington will get serious about reining in the deficit, particularly after the "cattle prod" of the S&P outlook, which will cause rates to fall. Legislation that raises the debt ceiling is expected to include meaningful spending cuts, while entitlement reform will not likely occur until after the 2012 election.

Fed Chairman Bernanke remains confident that the economy will continue to recover with inflation under control. Many economists, including those at the Fed, doubt that longer-term inflation pressure can take hold with unemployment still near 9%. The Fed indicated last month that it will not need to extend its \$600 billion bond buying program beyond its scheduled end next month. Bernanke said the Fed would initially hold its balance sheet, currently \$2.73 trillion including the \$1.7 billion in bond purchases from the first purchase program in 2009 and 2010, at current levels by reinvesting the proceeds of maturing Treasuries and mortgages. However, Bernanke indicated that as part of the Fed's anticipated exit strategy the reinvestment policy could be abandoned early in the exit process.

As the end of the Fed asset purchase program emerges and lawmakers debate the debt and deficit levels in Washington, bond yields are currently lower than when the government was running budget surplus 10-years ago. The U.S. Treasury 10-year note currently yields 3.23%, below the average of 5.48% in the 1998 to 2001 time period when the U.S. had a budget surplus. In addition to the deficit debate, additional factors that would be supportive of Treasury prices include a worsening of the European sovereign debt crisis, escalation of Middle East unrest, and additional declines in U.S. house prices. Lower commodity prices could also help yields to stay lower than they otherwise would have been. Bets against Treasury prices, known as shorts, likely peaked earlier this year, according to data from the Commodity Futures Trading Commission. As these positions reverse, the consensus estimates from over 70 economists surveyed by Bloomberg, for 10-year U.S. Treasury yields to average 4.04% by the first quarter of next year, may be too high.

Historically, Yields Rise w/ QE Implementation, and Contract with QE Termination

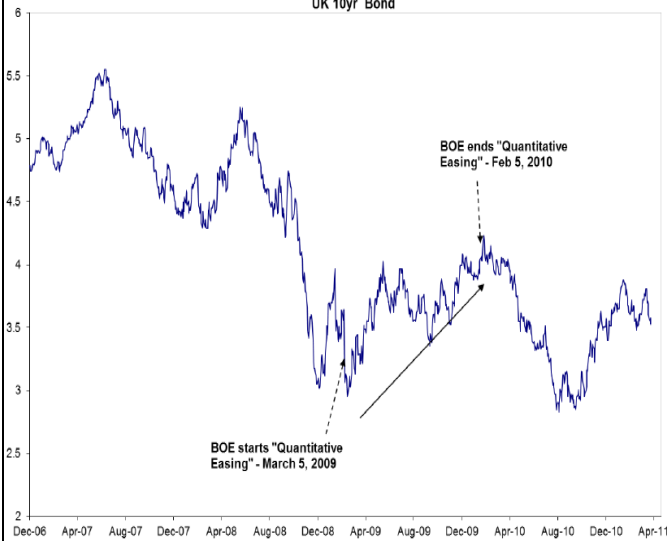
US 10yr Treasury



Source: Renaissance Marco Research

UK Yields Reacted Similarly

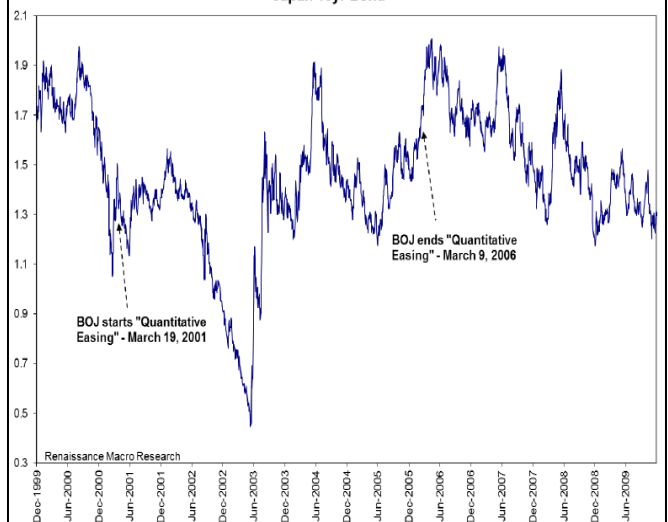
UK 10yr Bond



Source: Renaissance Marco Research

Even in Japan, Yields Contracted Post QE Termination

Japan 10yr Bond



Source: Renaissance Marco Research