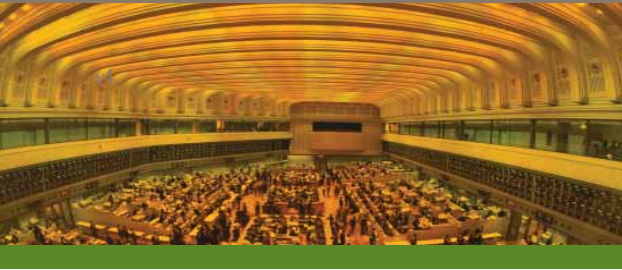


Bond Market Perspectives



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Highlights

- The impact will be greater for Agency Bonds and MBS.
- Within the Treasury market, TIPS stand to benefit more.
- We do not see a big new bond opportunity for bond investors and continue to prefer investment grade corporate bonds.
- We view Treasury buybacks to act more as a cap on interest rates rather than the start of a new Treasury rally.

Fed purchases will have a greater impact in agency and MBS markets.

A new giant in the bond market

Treasury yields fell by a sharp 0.25% to 0.40% following the Federal Reserve's announcement that it would buy \$300 billion in Treasury securities over the coming six months. Although the Fed had previously mentioned Treasury purchases, the timing of the move, announced along with increases in Agency and Mortgage-Backed Securities (MBS) purchases, surprised investors. Treasury yields have crept higher since the announcement but remain 0.15% to 0.40% below their levels before last week's FOMC meeting. We view Fed purchases as a positive for risk assets across the board; however, within the bond market we summarize the investment implications as follows:

- The impact will be greater for Agency Bonds and MBS, where Fed purchases represent a greater percentage of their respective markets and estimated new issuance.
- Within the Treasury market, TIPS stand to benefit more given the potentially inflationary longer-term consequences, their relatively small market share, and lesser liquidity.
- We do not see a big new bond opportunity for bond investors and continue to prefer investment grade corporate bonds.
- We view Treasury buybacks to act more as a cap on interest rates rather than the start of a new Treasury rally and longer-term decline in yields.

Fed purchases will have a greater impact in agency and MBS markets, as these purchases represent a greater share of the market. The Fed's \$300 billion Treasury purchase amounts to slightly less than 5% of the \$6.4 trillion of publicly held Federal debt. In contrast, expansion of agency purchases to \$200 billion (up from \$100 billion) and MBS purchases to \$1.2 trillion (up from \$500 billion) represents approximately 15% and 25%, respectively, of these markets.

Similarly and perhaps more importantly, in terms of supply/demand dynamics, Fed purchases of agency debt and MBS imply negative net issuance. In other words, these markets will be shrinking and creating a very favorable supply backdrop for investors. The three housing related agencies are expected to issue between \$100 billion and \$160 billion over the remainder of the year, while the Fed has now committed to buying \$153 billion more. Over January and February, net supply (which includes maturing bonds) of agencies averaged negative \$9 billion according to Bloomberg, and the Fed's purchase virtually ensures negative net supply.

In the MBS market, net supply is more striking, as \$1.25 trillion in MBS purchases will overwhelm Wall Street projections of \$400 to \$500 billion in new issuance. Add in principal repayments, and the agency MBS market will



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witness notable contraction. The favorable supply/demand backdrop is why we increased exposure to MBS in some of our more conservative models.

In contrast, the \$300 billion in Treasury purchases will amount to 30% to 40% of projected net issuance over the coming six months: a significant amount but certainly smaller in potential impact.

Within the Treasury market we believe TIPS stand to benefit more. First, the massive expansion of the Fed's "quantitative easing" raises longer-term inflation risks, and TIPS can hedge this risk. Secondly, TIPS represent roughly 13% of the overall Treasury market. A disproportionate share of TIPS purchases could move this relatively small market. Last, and on a related note, TIPS are less liquid than conventional Treasuries, and Fed purchases should improve liquidity, which can be a positive for performance.

We remain relatively neutral on TIPS. While breakeven inflation rates are low (1.33% on the 10-year TIPS), a similar 1.35% real yield (i.e., yield without inflation compensation) is low by historical standards and below the 2.0% 5-year average. With CPI expected to be flat for most of 2009, investors are left with low yield for return expectations. We would revisit the question if 10-year conventional Treasury yields approach 3.0%.

Investment Implications

Of all the bond sectors, we view the Fed's announcement as most beneficial for MBS given the greater impact to supply. It is clear this segment of the bond market is the Fed's focus. The agency MBS will shrink this year, creating a favorable backdrop for investors, and may push some investors into higher quality non-agency MBS, which remain deeply depressed.

Keep in mind that most agency MBS are priced at par or slightly above. Fed purchases coupled with President Obama's mortgage modification plan indicate that the vast majority of MBS can be refinanced, limiting the upside and leaving income as the dominant driver of performance.

Agencies are a clear beneficiary as well and certainly make a compelling alternative to Treasuries. However, absolute yields in this sector are low, reflecting their high quality and generally low level of interest rates.

We continue to prefer investment grade corporate bonds. Given their higher absolute yields, even a small of amount of yield spread contraction could lead to investment grade corporate bonds outperforming MBS and agency bonds. Furthermore, the TALF could be used to purchase corporate bonds if the Fed decides to take a step further. This would be a big positive for corporate bondholders. Precedence exists overseas, as the Bank of England (BoE) has been buying investment grade corporate bonds via its Asset Purchase Facility.

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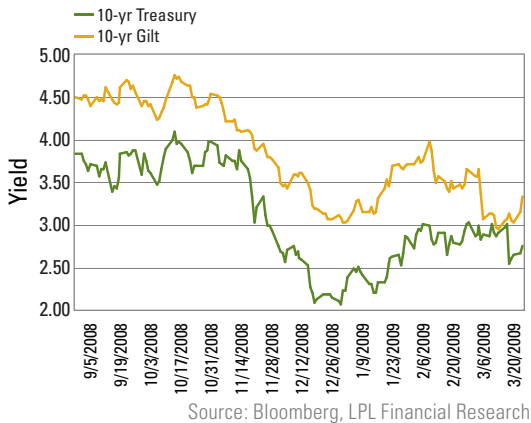
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Where do Treasury yields go from here?

We believe Fed purchases, which may be expanded after the initial six month period, will act more to cap yield levels and interest rates rather than spark a new rally. Put simply, the Fed's commitment over the coming six months



1 10-Year U.S. Treasury and 10-year UK Government Bond Yields



is significant, but it faces an ever increasing load of new Treasuries; \$1.5 to \$2.0 trillion in Treasury issuance is expected this year, and more is to come in 2010. And we would not be surprised to see this supply coupled with good news on the economy push Treasury yields higher, even with Fed purchases. Ultimately, we believe the Fed would increase their commitment if that occurred, further bolstering our expectation of a yield cap.

We believe the Treasury market may take its cues from the UK bond market. The BoE was the first to announce sovereign debt purchases in response to the credit crunch, and yields for 10-year UK government bonds (called gilts) dropped by 0.70% within a week of the bank's announcement. Since then, the 10-yr gilt yield has crept higher but remains 0.50% below pre-announcement levels.

The market's reaction this week may serve as a good barometer as the Treasury auctions \$94 billion in new 2-, 5-, and 7-year notes, while tentatively scheduled to conduct its first buyback late this week. Details of the first buyback have yet to be released

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The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

High Yield/Junk Bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

GNMA's are guaranteed by the U.S. government as to the timely principal and interest, however this guarantee does not apply to the yield, nor does it protect against loss of principal if the bonds are sold prior to the payment of all underlying mortgages.

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