

NCA BOND REPORT

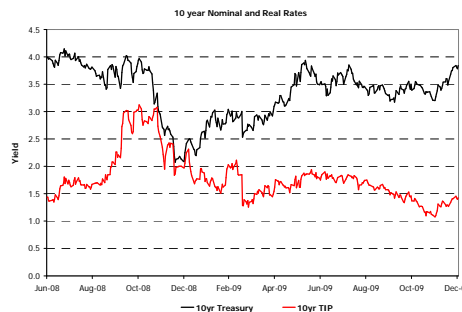
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LOOKING OUT

While we are always reviewing and sometimes rethinking what we know about markets, asset pricing and the prospects for future returns, the arrival of a new year is a natural time to put these thoughts on paper and share them with our friends and clients. After the roller coaster of the past two years, and with so many unknowns still lurking, this year we find the exercise particularly difficult. We are paid up members of the LAW OF RECURRING EVENTS CLUB, whose members believe things will be the same, this is just another cycle and each cycle has its idiosyncrasies. However, we have attended some meetings of the THIS TIME IT'S DIFFERENT CLUB, whose members expect a substandard recovery and are digging in to how relationships may have changed, how personal, company and government behavior may be altered by the events of the last few years.

As we look across the risks available in fixed-income markets, looking for value and where we will derive the elusive "alpha", here are some of our thoughts about where we have been and where we are heading.

- **Interest rates:** In the last 18 months, nominal and real yields did a round trip in opposite directions, ending up close to where they started. Ten-year nominal rates fell 190 basis points from 4.1% in mid-July 2008 to 2.1% at the end of 2008, and then backed up 170 basis points in 2009, to 3.8%. While 10-year treasuries returned a whopping 20.6% in 2008, they returned -9.8% last year. 10-year real rates were at 1.4% in mid-2008, but spiked to 3.1% during the financial crisis as investors dumped everything but nominal treasuries. In 2009, yields fell back to 1.3%, where they were when oil was \$145 a barrel. Normalization of financial markets—courtesy of the Fed, and the "cheapness" of inflation insurance contributed to the success of inflation-linked bonds in 2009.



- **Short-term nominal rates** have not come close to round-tripping. The 2-year treasury yield, ending 2009 at 1.1%, was 2.6% back in mid-2008; 2-year real yields were 1% in mid-2008, before they also tripled into the financial crisis, and now offer close to zero yield. Strong commercial and Central Bank buying coupled with the Fed's anchoring of the Fed funds rate has helped to keep a lid on short rates.
- The absolute level of nominal interest rates is low by historical measures, and may be rightly so, based on the US ability to grow. Nevertheless, we are squarely in the minority on this topic. The "pundits" are all calling for rising rates in 2010. How Nostradamian; the steepness of the yield curve already implies rising rates. We suppose these prognosticators also like the Colts (3:1) to win the Super Bowl. As Steven Crist once said, "there is no such thing as liking a horse to win a race, only an attractive discrepancy between his chances and his price." While rates are certain to rise if and when the recovery takes hold, we think rates will surprise in 2010 by staying low. If we were convinced that the recovery was a "V", we would be less optimistic about yields than we are, but we think there is a fundamental reason they will stay low for a while. While we are impressed by the improvements in financial markets, we think that de-leveraging by consumers and financial institutions has a long way to go. We are not convinced of the sustainability of growth without government stimulus and government support of financial assets. In 2010, we envision rates heading a bit lower before beginning to rise. We expect the recovery to come in fits and starts, which will provide us with trading opportunities around eventually rising interest rates.

HIGHLIGHTS

- *Better payroll and confidence data bring Treasury rates close to yearly highs*
- *Inflation assets outperform in a down bond market, but returns are negative in December*
- *Risk assets continue to outperform, equity, high yield end the year at highs*
- *Correlation between USD and equity breaks down as dollar rallies*

RETURNS

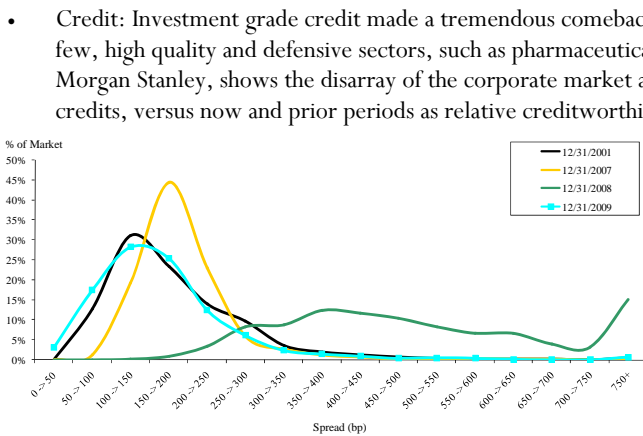
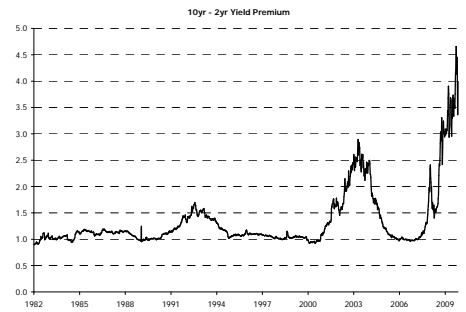
	Q4	2010
1-5 yr TIPS	2.13%	10.58%
TIPS Market	1.76%	10.48%
Global Linkers	-6.47%	13.21%
Barclays Treas.	-1.30%	-3.57%
Barclays Agg.	0.20%	5.93%

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LOOKING FORWARD CONTINUED

- Term Structure:** The Treasury curve has never been steeper. On a yield spread basis, 271 basis points separates the 10-year from the 2-year yield, more than 2 standard deviations from the mean. On a yield premium basis, the 10-year offers 4.2x the yield of the two-year, 5 standard deviations from the mean, a function of Fed Funds at close to zero, while Treasury auctions grow in size and the Treasury extends the maturity of its borrowings. The steepness of the curve implies considerable Fed tightening, about 150 basis points in the next 12 months, and we doubt the Fed will be that aggressive if they move at all (remember, the BoJ has been basically been on hold for 15 years). In 2008, the flight-to-quality caused the yield curve to steepen as short-dated yields fell, while in 2009 the extent of stimulus and government financing needs impressed the markets more than the fear of economic freefall, steepening the curve even more. Many believe that supply concessions will continue to steepen the yield curve in 2010, but we disagree. With short-term yields at zero and the Fed on perma hold, we think the carry trade is too generous to forego, and the curve will flatten as banks and others extend out the curve. Savers are desperate for more yield and banks continue to plow money into treasuries instead of lending, which should help to put a lid on long-term rates. In this context, we see the flattener and/or curve roll as attractive source of value in 2010.



- Credit:** Investment grade credit made a tremendous comeback in 2009, returning 16%. Corporate credit returned 19%, and just a very few, high quality and defensive sectors, such as pharmaceuticals and defense, returned less than 10%. The chart to the left, courtesy of Morgan Stanley, shows the disarray of the corporate market at the end of 2008, when the market was making few distinctions between credits, versus now and prior periods as relative creditworthiness is better assessed. Still, the yield premium of investment grade corporate

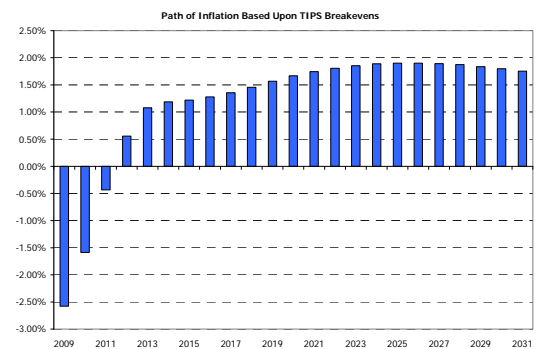
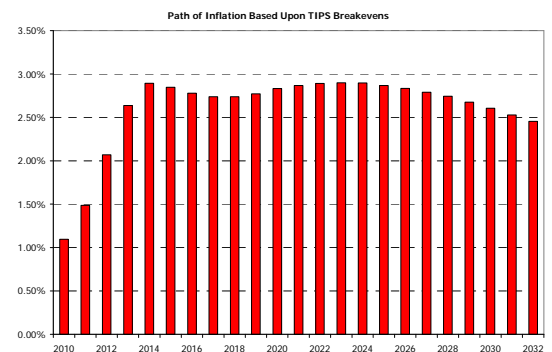
bonds versus treasuries is wider than average, with the more troubled sector, financials, offering a 50% premium, while industrials offer a 32% premium. These absolute yield levels are low (e.g., 4.6% and 5.2% respectfully), which made 2009 a fine time for corporate issuance which was over \$700 billion in 2009. We do not expect 2010 to be a rising tide for all credits as it was 2009, and it will be an opportunity for investment managers to distinguish themselves by selecting companies/

industries that are bondholder friendly (i.e., those which can issue stock vs. bonds, increase top line via market share or pricing, de-leveraging, etc.). We find such names in the metals and mining, insurance, industrials arena, and even continue to find REITS attractive. Our underweight sectors are the staples, food, beverage, retail, and building companies.

- The securitized commercial real estate market and asset-backed markets were the beneficiaries of government support in 2009, as the TALF and PPIP programs reintroduced leverage into the system. Despite the spread compression, certain assets still offer value, specifically commercial mortgages. High quality, well protected CMBS still trade considerably wider than other comparable non-agency asset classes. While fundamentals remain weak and should continue to deteriorate in the near future, investors should position for a gradual recovery that will be the theme in 2011. Technicals remain supportive as well. Most of the same factors that drove spreads tighter in 2009 will continue in 2010 including good relative value, very limited supply and continued government and investor support.

- Inflation:** Any way you look at it, inflation plunged into mid-2009, as year over year CPI registered -2.1% in July, returning to a $+1.8\%$ rate in November's report. Housing, the largest component of CPI (43.4%) was down year over year -0.7% in July and was still running at a negative rate in the most recent report.

Nevertheless, given the extent of stimulus, and the mispricing of inflation indexed securities during the financial crisis, it is not a wonder that the TIPS market, and inflation linked markets abroad, outperformed their nominal peers. The two charts on the right of the page show the path of inflation as priced in the TIPS market, at the end of December 2008 (blue) and the end of 2009 (red). The change in inflation expectations resulted in a great year for TIPS and other IL markets. While some might claim that the relative performance of IL bonds had more to do with the poor nominal markets, they overlook the positive returns gleaned while treasuries declined. The inflation markets are now priced for a rise in inflation at this point. Most economists, as well, expect inflation to be a positive 1-2% during 2010. With the future path of inflation priced close to that rate, we are expecting some volatility in breakeven inflation and in IL accounts we will add value by owning nominal bonds during some periods in 2010. Betting against TIPS versus nominal bonds was a losing proposition last year, but



LOOKING FORWARD

we believe there will be better opportunities to add value via breakeven-inflation trading. To be sure, this trade will not be for the faint of heart. Supply, or lack thereof, will continue to be a factor in the IL markets, putting a ceiling on TIPs yields. Further, the prevalence of non economic buyers and asset allocators entering the market are likely to over power fundamentals, as they did in 2009.

- Non-US: 2009 brought a reminder that creditworthiness matters even in the developed sovereign world. This was brought home by the performance of Greece's debt spreads, which had a wild ride (from 50 bps to 300 bps over Euro 10-year debt, back into 100 bps and then back out to 275 bps) vs. its European Union counterparts, given the extent of that country's fiscal problems. As part of the EMU, Greece has violated the parameters of membership, and most likely was a violator right from the start. The extent of the EMU's willingness to bail out a member of the club, or risk the consequences of a departure are yet to be determined. To the extent that most developed countries have increased debt issuance, and will continue to do so to support stimulus in the face of a "balance sheet recession," all have become riskier from a credit perspective. Nevertheless, in order to eventually grow themselves out of the problem, this is the path most countries have chosen. In short, we believe Sovereign credit will become household words in 2010 as bloated balance sheets intersect with unsustainable social programs. Europe will take center stage for this shakeout. We believe the great convergence trade that took place in the EU will further unwind separating the Thoroughbreds from the PIIGS (Portugal, Ireland, Italy, Greece and Spain) and threatening the EMU. Buy puts on the Euro.

That's not to say there aren't opportunities overseas. We like countries which are improving their creditworthiness, via growth and improved policies. Many emerging markets countries fit this profile and many are investment grade in rating. Asian countries are particularly attractive as we believe they will be able to continue to attract capital, which will be a very important driver of returns going forward.

- Volatility: From its peak at 80 in late 2008, the VIX Index reflecting equity option volatility fell to 20 and the MOVE Index, a measure of interest rate option volatility fell from 265 to 108. What does this mean? That the distribution of expected price outcomes has narrowed, and is now close to "average." Not below average, as it was from 2003 through mid-2007, but average. In a way, this is encouraging, since it suggests that there has been some confidence restored in the market's ability to function. One might think this could set the stage for long-term investing, by both people and companies. The options market is a bit surprising to us, as there has been little in the way of reform of regulatory oversight, and we see little evidence that there is going to be any. We think markets are complacent versus the possible outcomes. Maybe they just wore out, but we expect considerable surprises ahead. Where might the surprises come from? Both internal and external sources, and we would point to the current fascination with the Chinese economy as being an excellent source of volatility, not to mention concerns about sovereign defaults (recently Dubai), US recovery and last but not least terrorism. To capitalize on this complacency we would recommend buying volatility. We favor directional hedges like puts on the S&P 500 and calls on the US dollar.

In short, we remain skeptical of a strong economic recovery in 2010. Strip away the fiscal and monetary tailwinds and serious issues remain: unemployment, rising energy prices, tight credit conditions for consumers and small business, over zealous regulators, mis-guided policies, rising mortgage rates, rising loan delinquencies, debt levels and de-leveraging, deteriorating state and local government balance sheets to name a few. Shall we go on? That's not to say there aren't opportunities; there is always money to be made. The question always comes back to whether investors are getting paid for the risks that they are taking. As the market swings from the depths of fear to irrational exuberance, risk premiums will shrink and asset valuations will get stretched. 2009 was an exceptional year from a risk/reward standpoint, but 2010 is not nearly as compelling. The current environment will require a disciplined approach and careful risk management. We are looking forward to it!



RETHINKING FIXED INCOME

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HISTORICAL DATA ON GLOBAL INFLATION LINKED BONDS

The global sovereign inflation-linked bond market is about \$1.5 trillion in size. US TIPS remain the largest component of this market at \$543 billion, followed by the Eurozone, at \$280 billion. Importantly, issuance from historically inflation-prone countries has increased significantly over the last two years, and now amounts to \$230 billion.

The historical performance for these instruments is below. Overall, this class exhibits excellent risk-adjusted performance and diversification benefits. Note the difference in volatility among the market indexes, with the overall TIPS market reflecting the volatility of longer-dated real interest rates, compared to the less volatile TIPS 1-5 year index.

Correlations have not been stable. In the more recent period, all correlations to the S&P 500 increased from the 5-year period. Part of this was a result of leveraged market participants being shaken out of their holdings last year. The superior correlation of the Barclays Aggregate Index (formerly Lehman) was the result of the extreme flight to Treasuries, which make up 22% of the Index. Going forward, we expect this trend to reverse, as credit spreads within the Aggregate have tightened significantly along with the equity indices this year.

	History of Inflation-Linked Bonds						
	Annualized Return			Volatility	Information Ratio	Correlation to S&P 500	
	1 Year	3 Year	5 Year	5 Year		2 Year	5 Year
U.S. TIPS	10.48%	6.67%	4.62%	7.22%	0.64	0.46	0.29
U.S. TIPS 1-5	10.57%	6.39%	4.63%	4.25%	1.09	0.43	0.29
Global Linkers	13.21%	5.48%	4.40%	9.63%	0.46	0.62	0.47
Global Linkers Hedged	8.83%	5.48%	5.36%	5.94%	0.90	0.60	0.51
Lehman Aggregate	8.63%	6.94%	5.50%	3.64%	1.51	0.30	0.17
JPM Global Nominals	3.83%	6.36%	4.71%	9.03%	0.52	0.43	0.32

*as of 12/31/2009

RETHINKING FIXED INCOME

In rethinking fixed income, we are helping investors optimize their use of fixed income by stepping back and examining the full spectrum of investment possibilities, based on their needs and constraints, to tailor a strategy most suited to their goals. We start by identifying and parsing the risks that will best meet their needs; then we draw upon the toolkit of available securities and investment techniques to construct a customized portfolio.

Rethinking fixed income means:

- Taking a creative approach to fixed income management—one that fully exploits the wealth of possible investment vehicles, approaches and market inefficiencies within the client's investment parameters.
- Taking an approach to active management that is explicit about parsing risks; that estimates the impact of active bets; that exploits relationships within the broader fixed income asset class (through such techniques as overlays); and that utilizes multiple sources of risk through a budgeting process.
- Reexamining benchmarks to identify the one most aligned to the client's purpose, rather than arbitrarily accepting conventional benchmarks, which often have little bearing on the investor's investment goals.
- Fitting the investment strategy to the investor, not vice versa.

