

NCA BOND REPORT

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WHAT'S NEXT?

Autumn and risky assets have traditionally not gotten along. Remember last year's near-death experience for the economy (we ask jokingly)? A quick reminder for those with short memories:

- Sept 15: Lehman goes bust;
- Sept 20th: Treasury drafts TARP;
- Sept 29th: The House rejects TARP (to be passed a few days later);
- October 6-10: Worst week for the stock market in 75 years.

Now that was a painful season for risk assets. 'Fall 2008,' or some variation of these words, will no doubt be etched into the financial lexicon like 'Black Monday,' i.e. a quick reference to panic and risk aversion. Flash forward to today and we are witnessing a dramatic recovery in risk asset prices that in some cases have returned to pre-Lehman levels.

The current risk rally has been driven by improving economic data (or data that does not cause complete despair) and the resulting rush to get long anything with a bent toward risk. In other words, the impetus for buying risk is to: 1) to keep up with benchmarks and 2) convince clients that you should not be fired. This may be a self-reinforcing phenomenon despite lingering doubts about the economic recovery. As money managers, we have to force ourselves to look both backwards and forwards. We ask ourselves the same question over and over: What's next? It seems that a popular narrative these days among the financial media is to discuss the daily market actions in a binary scenario, i.e. *today is a "risk on" day*. Usually this translates simplistically to what direction equity futures are moving. Broadening the view of the investment world, we do note that correlations have been very high among risk assets. And we think these high correlations will not last forever.

Risky asset classes have outperformed since March. The Barclays US High Yield Index has put in over 50% this year. We submit an anecdotal example that perhaps suggests the rally is somewhere between adolescence and full-maturity. Last month, Blockbuster, a B rated name issued \$675 million in debt. The debt carries a coupon of 11.75%, the issuance price was 94, so yield to maturity is 15%. Now, in our opinion, this is not the worst company in the world, despite declining margins and revenue growth. And it is possible that Blockbuster can continue to make money as it transforms in the "on-demand world." Twelve months ago, Blockbuster would not have been able to issue debt at any price. The credit markets have certainly come a long way. Our concern is that given the state of the US consumer and the plethora of entertainment options available, we think that the pricing for this issuance seemed a tad optimistic. After all, when was the last time you set foot in a Blockbuster? We have not in a while. And, we are seeing more evidence of optimistic pricing like this on a daily basis.

Furthermore, we have seen a lot of research reports suggesting a rotation of credit positions into high-yielding dividend stocks. The pitch being something like: a 10-year, A-rated Verizon bond will give you a 4.8% yield, while the Verizon equity will deliver a 6.5% yield. Given one's feel of the equity market, this may make sense. Though, without complicated hedging, one is still long specific equity risks.

Hide out in Treasuries? In theory, that may make sense for the risk adverse, but we were very interested to read in Bank of America's recent *Hedge Fund Monitor* report that there is a large speculative crowd piling in and shorting 10-year notes. In other words, a large portion of the "smart money" is betting on a collapse in bond prices. Continued shorting or short covering could add a lot of volatility to this asset class in the near term. What about commodities and currencies? Gold and the U.S. dollar are moving inversely to each other, and oil is not that far behind. A reversal in one asset class could have a dramatic impact on the other.

Lastly, we cannot ignore geopolitics. This is something that is very hard to model. But, while the financial world was busy buried in "green shoot" search parties, the world keeps spinning, and nations continue with their own agendas. At some point, geopolitics may re-enter the picture.

Thus, we argue that the investing world is about to move past this binary paradigm of "risk on" and "risk off" rather quickly. What's next? We remain vigilant and believe the sigh of relief from last year's panic may quickly be replaced by new challenges that quickly emerge.

HIGHLIGHTS

- *Bernanke pronounces recession "likely over" in mid September*
- *Stocks rally 15% in 3rd qtr, HY bonds up 23%*
- *Nominal Interest Rates fall and curve flattens as Fed promises no hike*
- *Real Rates fall and curve steepens as the future path of inflation moderates*
- *Commodity/EM Currencies appreciate, Dollar slides to 12 month low*

RETURNS

	Q3	2009
1-5 yr TIPS	2.28%	8.27%
TIPS Market	3.08%	8.58%
Global Linkers	5.05%	12.20%
Barclays Treas.	2.10%	-2.29%
Barclays Agg.	3.74%	5.72%

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EYE ON INFLATION

Since our last writing, 10 year breakevens revisited their highs of the year, before dropping 29 bps in 6 trading days only to once again revisit the highs of the year. In the good ol' days (pre Lehman) market moves of this magnitude were a big deal. In fact, prior to Lehman's demise, a move this large happened only once (March 2008). However in the brave new world, we have

6-day Trading Periods				
	Bps move	7 years	2 years	1 year
Frequency	(1.00)	0	0	0
	(0.75)	2	2	2
	(0.50)	6	6	6
	(0.25)	22	22	21
	0.00	895	242	107
	0.25	868	216	92
	0.50	34	34	34
	0.75	1	1	1
	1.00	0	0	0
Total		1828	523	263
-25 bps or less		30	30	29
Percentile		1.64%	5.74%	11.03%

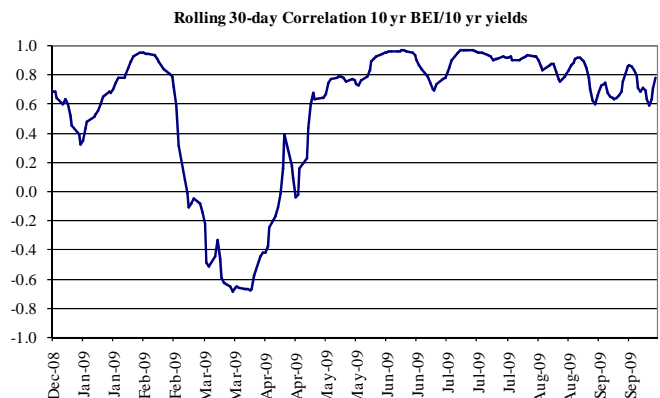
experienced moves of this magnitude or worse, a whopping 29 times or 11% of the 6 day trading periods. This truly underscores the elevated volatility we discussed last time.

Similar to the Huxley theme, our brave new world is in many ways more of a dystopia than a utopia. This is particularly true for buy and hold investors. The flip-side, of course, is there are opportunities to profit from this type of volatility. Consider the directionality of breakevens.

Movements in breakeven inflation rates have been extremely directional this year, taking their cues from the movements in nominal yields. As the following chart shows, the rolling 30-day correlation between 10 year yields and 10 year BEIs was above .7 for almost 5 months. This is a pretty impressive

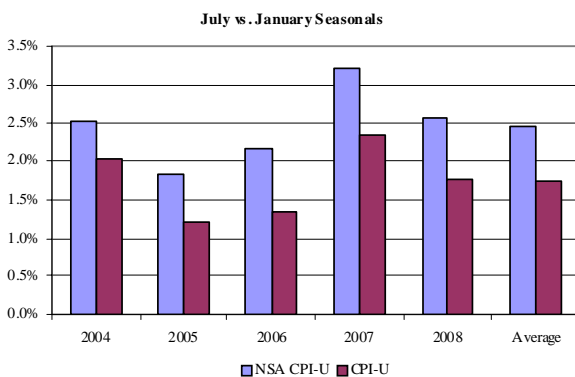
stretch. To put this in perspective, the average correlation over the last 9 years has been .49.

In this context, for much of the year it was difficult to separate a breakeven position from an outright view on rates. Recently we've seen this relationship break down with BEIs falling when the market sells off and vice versa. We view this as an important development. From a tactical standpoint, we think the TIPS market and BEIs has been driven much more by technical insurance buyers than by fundamentals. Other than an inflation inducing policy error, we are hard pressed to find much that favors inflation over deflation. Excess capacity in labor and product markets remains at nearly unprecedented levels and wholesale pricing data continues to show a lack of pricing power. At this juncture, we favor tactically fading TIPS at these levels.



That's not to say that we don't think interesting opportunities exist in the TIPS market. For those who can stomach the tumult of insurance buyers and profit takers, we think that valuations are compelling from a long term perspective. Further, despite the "normalization", we continue to see some glaring mis-pricing in the

TIPS market. One mis-pricing is related to the value of the seasonals associated with different maturity points. For instance, the following chart shows both CPI-U and NSA CPU-U between November 15 and May 15 for the last 5 years. These dates are significant because they determine the seasonal value between January and July maturity TIPS.



As can be seen in the chart, there are positive seasonal forces (i.e., non seasonally adjusted is greater than seasonally adjusted) which favor July bonds over January bonds. Without getting into the reasons for why this occurs or why the trend seems to be growing more pronounced, investors can and should factor this value into their security selections. Yet, there is no evidence that this is happening. In fact, we see all the July bonds as being cheap to both April and January bonds. A perfect

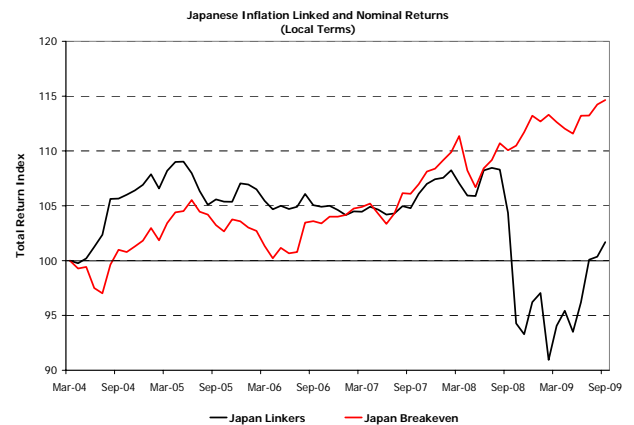
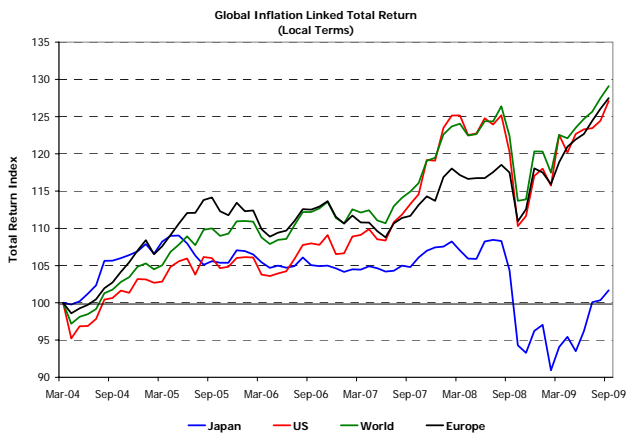
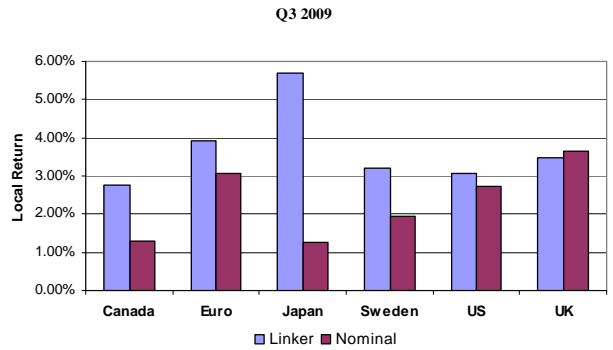
example is the July 2012, which yields .55% vs. the January which yields .48% and the April 2012, which yields .46%. The curve is worth .16% but the seasonals are worth -.32%. Given that the floor value on both is negligible, this suggests that the July 2012 is about 23 bps too cheap.

	Yield	Curve	Seasonals	Floor	Fair Value
1/15/12	0.48%	-	-	0.01%	0.47%
4/15/12	0.46%	0.08%	-0.13%	0.15%	0.54%
7/15/12	0.55%	0.16%	0.32%	0.00%	0.32%

INFLATION LINKED BONDS

Inflation-linked bonds had good returns in the third quarter, although they paled by comparison with riskier asset classes. In local terms, global linkers returned 3.5%, and with the appreciation of the Swedish Krona (10.8%), the Yen (7.5%), and the Euro (4.5%), the unhedged return was 5.1%. Japan's market was an outlier, returning 5.7% for the quarter, a far better showing than this market has had in a long time.

Japan's I/L program has been a MAJOR disappointment for investors. In the 5 years that Japan has issued inflation linked bonds, their cumulative total return has been 1.7%, compared with 27.1% for the World Government IL Index as a whole, and the other majors, as the chart below left shows. The chart to the right compares Japanese linkers to their nominal counterparts, which have appreciated 15% in the same period. The story involves a strategic misstep by a sovereign issuer.



Source: Barclays, New Century Advisors

Japan's sovereign bonds constitute 32% of developed market *nominal* debt outstanding, as reflected in the JP Morgan Global Bond Index. US sovereign debt is 26% of this index, *down* over 15% from its weight in 1999 -- but that is changing as the US fiscal stimulus proceeds.

Japan's percentage is 44% *higher* than it was at the end of 1999, reflecting Japan's relative issuance over these years. The debt expansion is a function of Japan's weak growth, its aging population which requires increasing social security transfers, and the government's numerous fiscal stimulus plans to encourage domestic demand and thus diversify away from a mercantile model.

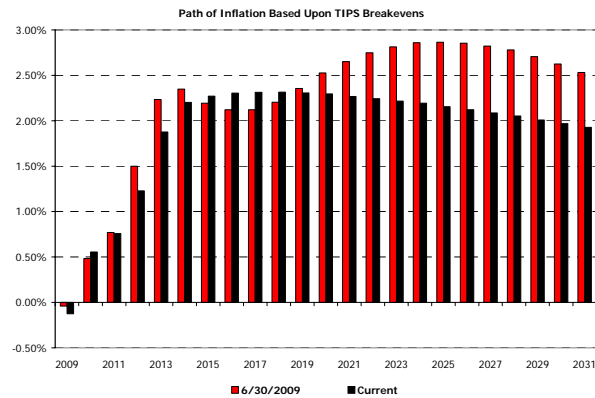
Japan initiated its inflation-linked program in 2004, when year over year CPI had increased from negative to positive territory. The appeal of linker issuance to a sovereign is to save money for the Treasury, since real yields are expected to be lower than nominal yields. And, on average, Japan's real yields were 75 basis points less than nominal yields. Like other sovereign issuers, they expected they could also expand distribution for government debt by issuing in this channel. The government rapidly grew the outstanding linker debt to over 10 trillion yen (\$90 billion) rising to 7% of the Barclay's Global Inflation Linked Index. However, the structure of the Japanese linker left something to be desired, especially in a country which is prone to bouts of deflation. Here is the kicker: unlike it's US, and Euro counterparts, Japanese linkers do not have an embedded deflation floor, so at maturity, par is not guaranteed!

Last fall, as we painfully remember, global linkers were dumped, and deflation was rapidly priced into all linker markets. A simple way of thinking about it is that real yields were then higher than nominal yields. The 10-year Japanese linker's breakeven went to *minus* 4.3%, whereas the US linker of the same maturity went to just zero. Thus, the floor embedded in US linkers prevented a Japanese-type scenario. Even before the crisis hit, and recognizing the lack of demand from investors, The Bank of Japan began buybacks of outstanding linkers, and they ramped up the program considerably in 2009. Thus, an estimated 31% has been taken out of the market in all. *It is the buyback of the outstanding linkers, and the potential for continued buying, that has resulted in this year's*

improving performance. Just like the impact of the Fed's TARP program, the commitment by government to support the JGBI market provided improved liquidity and narrower spreads.

Breakevens in Japan have recovered from the -4% zone, but we would argue that at about -1.25% for the next 10 years, they still offer some value.

Switching now to the US market, as we point out in the attribution section below, the third quarter saw TIPS outperforming nominals with the exception of the long end, where nominals outperformed. The chart below shows what this looked like in terms of the path of inflation as priced into the TIPS market.

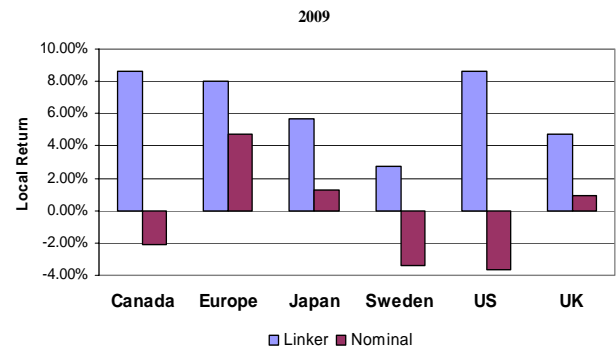


Note that inflation expectations beyond 2013 were well above 2% at the end of June, and were close to 3% at the longer end of the yield curve. But they dropped considerably during the quarter, as long Treasuries saw demand at yields which reached 4.5%

remained at \$40 billion. With \$43 billion in TIPS maturing in 2010, the Treasury will have to issue that amount to keep net issuance from falling. Furthermore, as foreign central banks become more concerned about their huge holdings of US Treasuries, and as the US appears to be willing to deflate the dollar in its efforts to reflate the economy, the appeal of TIPS to foreigners is increasing. We expect the supply of TIPS to increase to meet this increased demand, as the Treasury is likely to announce early in November. As was extremely clear from October's 5 year TIPS auction, with a bid to cover ratio of 3.47, there is clear demand for the inflation insurance.

Explaining the very good returns of US TIPS this year, in a period in which actual inflation has been declining, has much to do with the supply of TIPS. The short story is that at about \$500 billion outstanding, there are simply not enough to go around. While net Treasury coupon issuance increased sixfold from FY 2008 to 2009, net TIPS

issuance



Source: Barclays & NCA

TIPS MARKET RELATIVE RETURNS

After negative returns in the first half, nominal Treasuries had positive returns in the 3rd quarter. However, risk appetite and the demand for inflation insurance resulted in TIPS outperforming their nominal comparators, with the exception of the long end, where nominal treasuries outperformed. In this period of improvement in liquidity and normalization, to some extent, of inflation expectations, TIPS have been one of the better performing sectors of the fixed income markets. The primary source of return was price, as real yields fell over 100 basis points at the at the short end of the real yield curve as the path of expected inflation went from deflation to very low inflation. Inflation accrual, at a negative 53 basis points year to date, reflects the actual decline in NSA inflation that was accrued from October, 2008 through the end of July, 2009. The biggest drop in NSA CPI occurred at the end of last year, as the price of energy commodities fell more than 50%. Thus far in 2009, NSA prints have been positive in most months.

	TIPS		Nominals	
	1-5 Year	TIPS Market	Barclays Treasury	Barclays Treasury 10+
Q3	2.28%	3.08%	2.10%	4.53%
2009 YTD	8.27%	8.58%	-2.29%	-8.01%
TIPS Market Attribution				
	Total Return	Price Return	Coupon Return	Inflation Return
Q3	3.08%	1.51%	0.55%	0.98%
2009 YTD	8.58%	7.34%	1.65%	-0.53%

CURRENCY RETURNS YTD

- AUD 28.95%
- CAD 14.59%
- EURO 5.87%
- KRONA 13.40%
- STERLING 10.64%
- YEN 1.44%

SOURCE: BLOOMBERG



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	5.69%	5.58%	4.77%	7.07%	0.67	0.35	0.21
U.S. TIPS 1-5	3.39%	5.53%	4.38%	4.18%	1.05	0.32	0.19
Global Linkers	5.52%	5.70%	5.73%	9.53%	0.60	0.50	0.38
Global Linkers Hedged	6.05%	5.52%	5.47%	5.85%	0.94	0.50	0.40
Lehman Aggregate	13.38%	7.31%	5.66%	3.56%	1.59	0.19	0.04
JPM Global Nominals	10.84%	7.87%	7.22%	9.01%	0.80	0.31	0.24

*as of 09/30/2009

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.

