

# F.I.R.S.T

## Fixed Income Research and Strategy Trends



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## How Do We Cover the Exits?

Our great recession — 18 months’ worth — has ended, and risk markets have roared back. At some point, accommodations will be unwound, though it is too soon to call for a change in monetary policy. The risk is that economic recovery may not match the market recovery. It could be frail. A stubbornly high unemployment rate points that way. Historically, the Fed waits months after unemployment has peaked, an event that has not yet occurred. Inflationary forces are also subdued. Low inflation can cause restraint on the policy rate trigger, or it could at least compel a more gradual change in its pace of adjustment. Employment, inflation trends and inflation expectations are the factors the Fed is watching most closely.

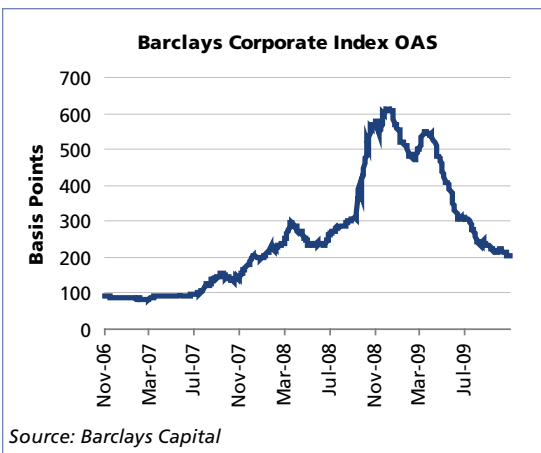
While many fear inflationary forces, the consensus call is for a low-growth “jobless” recovery; however, this is by no means certain, as even fiscal stimulus could fade given the state of government finances. Yet, some economic props are starting to fall. This is the start of an expected sequence of pulling away the supporting pillars, as policymakers seek to find how this whole thing can stand on its own. This is the reality check of the exit strategy.

Strongly supported by its commodities exports, Australia has raised its policy interest rate twice this fall. Norway has done it once. Since these events, markets have become skittish as they try to handicap the repercussions of the removal of accommodative policies around the world. What is clear at first is that global growth rates are widely disparate. As countries climb out of the financial crisis, removal of accommodation will not be coordinated. The U.S. is perceived as a laggard; this impacts the currency most immediately, though it also affects rates and the credit markets.

We remain optimistic on the prospects for credit securities. That said, while credit fundamentals have improved, the price change in risk securities has recently moved from a sharp improvement to a much slower grind. As valuations stabilize overall, performance inside sectors has begun to diverge, based on issuer and security specific considerations. This is a far different paradigm than the rising tide that lifted all ships somewhat less selectively earlier this year. Discrimination over credit specific outcomes should continue. While overperformance of credit in general is consistent with a stronger economy — and


would be expected to remain so even when policy rates are increasing — the macro trend of riding a credit wave is giving way to more security selection skills. For example, as exports will be a key driver of U.S. growth (contrasted with consumer spending, which is likely to lag), some credit risk reshuffling is expected going forward.

**Credit spreads have narrowed sharply though have not completely returned to pre-crisis levels. Graph captures corporate spreads over treasuries as measured by the Barclays Capital Corporate Index.**



The initial unwind of accommodative policies — the knocking away of the support columns — has started. The Fed’s purchases of Treasury securities reached its \$300 billion goal, and the agency debt and MBS programs are nearing their phased exits. The New York Fed is gearing up reverse repo programs and other operations with the intent to unwind the alphabet soup of government initiatives that have provided extraordinary liquidity to the financial system, without disrupting markets or the economy.

If the sum of these programs simply created a mountain of cash in the economy, we’d be concerned. Instead, these steps filled a hole left both by a weakening in loan demand and by zombie banks unwilling to lend. Unwinding it all, however, will be fascinating. Seeing how far deficit financing can run, before that falls in its own hole, will be too. Together these make 2010 shape up as an intriguing year. ■



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