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Market Commentary

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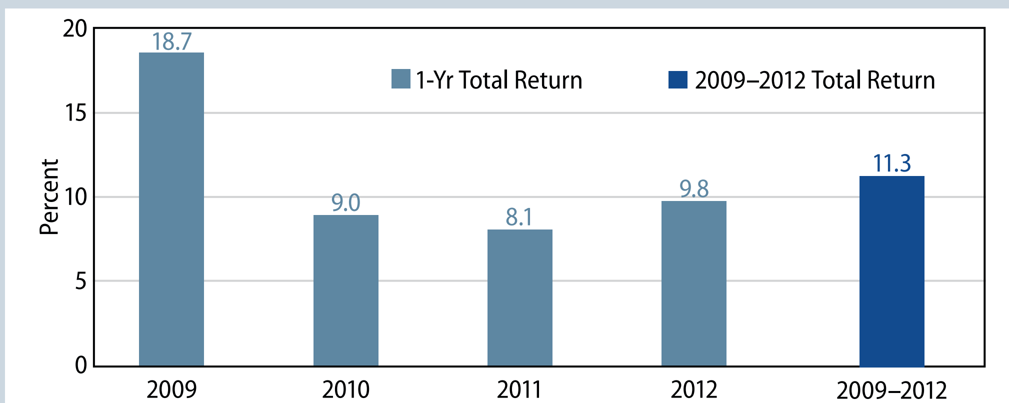
This man Wellington is so stupid he does not know when he is beaten, and goes on fighting.
~Napoleon Bonaparte

In the aftermath of the financial crisis, our investment thesis has been that the global recovery would prove to be enduring but extremely sluggish and that, despite anaemic growth, the risk premium due to systemic risk would slowly recede. Such a recovery would look something like two steps forward, one step back. Pitfalls and recurring crises would necessitate more aggressive repositioning and additional diversifying strategies. The one asset class we felt was a definitive favorite to rebound strongly, however, was that of investment-grade corporate bonds. Our view, articulated in these notes over the last few years, has been that this asset class was the most undervalued in the crisis. The implied probability of default at-the-wides was many times the default levels actually reached in the Great Depression. The volatility of corporate bond spreads has been severe. Still, corporate bond returns have been nothing short of breathtaking (Exhibit 1), as yield spreads have returned to their 25-year average (Exhibit 2).

Exhibit 1
US Corporate Investment-Grade

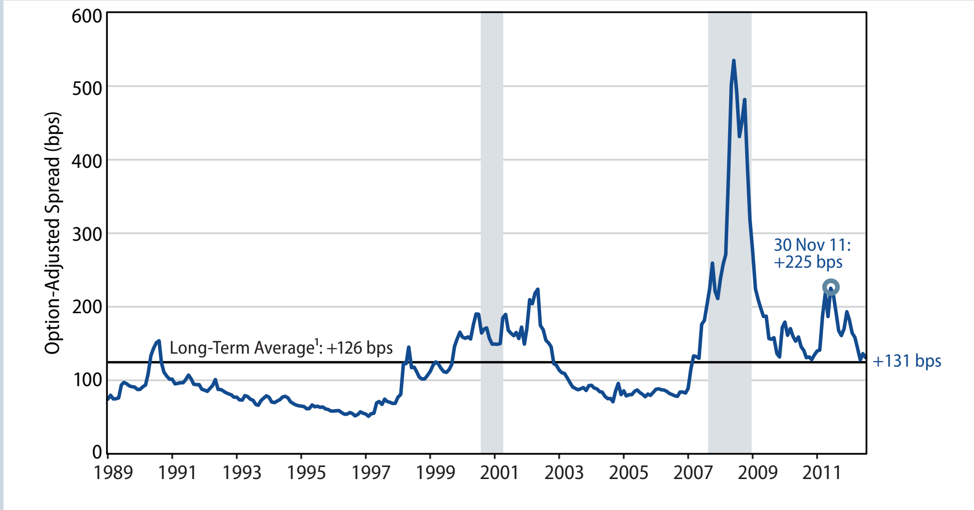


Source: Barclays

Our central contention has been that investors needed to be thoughtful about systemic versus cyclical risks. The enormity of the risk premium embedded in risk assets engenders a strong disposition to stay long. The more conventional call to remain cautious in case growth were to undershoot expectations was trumped by the need to mine near-depression-level valuations as systemic risk diminished. Last year was a further example: US and global growth downshifted meaningfully at mid-year, but policy was implemented to further reduce the chance of any renewal of systemic risk, particularly in Europe. Once again, staying long based on exceptional valuations as tail risks further receded beat other, more defensive strategies based on reasonable concerns over sub-par cyclical performance.

These spectacular corporate bond returns of the recent past (Exhibit 1) are not repeatable. With the long and profitable road of mean reversion now behind us, the question becomes, "Where do we go from here?" The arguments that systemic risk has been meaningfully reduced, but not eliminated, and that sub-par growth concerns persist, suggest that a meaningful discount to fundamental value may still be necessary.

Exhibit 2
Barclays U.S. Credit Index: Option-Adjusted Spread



Source: Barclays. As of 31 Dec 12. Periods of recession highlighted in pale blue.
[1]Average since June 1989

The backdrop of exceptional corporate fundamentals aided by extreme management conservatism may also be peaking, as increasing dividends, share buybacks and percolating M&A activity suggest.

Corporate volatility is another portfolio issue that now merits serious consideration. Given the present, modest incremental yield advantage, how much do spreads have to widen before the total return is reduced to that of US Treasuries? More importantly, what volatility assessment do we use in evaluating this likelihood? Using the magnified volatility of the crisis and its aftermath, today's yield spread advantage seems very modest.

These conditions lead us to continue reducing corporate overweights to realign them with the less favorable risk/reward characteristics of today's spread environment. However, we are still persuaded that some overweight to the position should remain. Valuations still retain a cushion for systemic risk. The ongoing recovery both globally and in the US suggests risk levels will continue to diminish. Ratings agencies have been much more cautious. Corporate balance sheets and cash-flow fundamentals have been extremely strong. In such an environment, the zero default rate of the last two years is instructive; with diminishing risk should come diminishing volatility.

Demonstrating a singular focus on keeping monetary policy easy to restart economic growth with near 0% policy rates and negative real rates, central bank actions have been another powerful suppressant of yield spreads. The enormity of a close to 6% output gap suggests these policy rates may be with us past the Federal Reserve's (Fed) current 2015 guidance. Investors desperate for yield face a choice: go down in quality or out on the yield curve. For many, even those who remain very pessimistic about growth prospects, the easiest step is the slight quality give-up to investment-grade credit, as opposed to the higher risk asset classes or long-term bonds. Spread volatility may be troublesome, but ultimate capital preservation is highly likely. If conditions continue on their recent path, and the Fed stays true to its forward rate guidance, then spread tightening should continue its trajectory, albeit at a reduced pace.

This is the ultimate challenge of accepting moderately higher yields for spread volatility. Historically, investment-grade corporate bonds have been considered a low-risk asset class (a simple but now controversial comment based on recent experience). Investors accept a small increment in yield in exchange for accepting less liquidity and *de minimis* default risk. As we all know from Finance 101, the yield pick-up should be slight, the liquidity reduction should be very modest, and the volatility of the yield spread should be very low. We are a long way away from those conditions today but over time, isn't that the direction in which we are headed? Unlike the violence in spread moves in higher risk sectors such as high-yield or emerging markets, the greater certainty of final principal repayment suggests a substantially lower volatility. It even suggests the possibility of a differential return profile. Recall our earlier notes considering the experience in Japan over the last 18 years and the US in the late 1930s: in both cases, despite economic challenges that were worse than even the most pessimistic forecaster might have been able to predict, investment-grade credit was an exceptionally strong performing asset class.

To simplify the discussion boldly, is investment-grade credit a surrogate for the Treasury market or the stock market? If systemic risk is receding, even in a low-growth environment (as highlighted by these historical examples), investment-grade credit will continue to do well. So we come to the key question: will systemic risk continue to recede? Have policymakers done enough with the banks and in their monetary policy regimes to truncate tail risks sufficiently? Or will growth be so disappointing that even in the face of relentless and renewed policy action, the globe will find its way back to crisis?

Certainly, the mountain of excess return over US Treasuries is behind us, and the risk/reward profile now poses a much tougher question. Reduced position sizes are needed to temper risk. The direction of the yield spread, though, should still be irregularly tighter.

A Trip Down Memory Lane

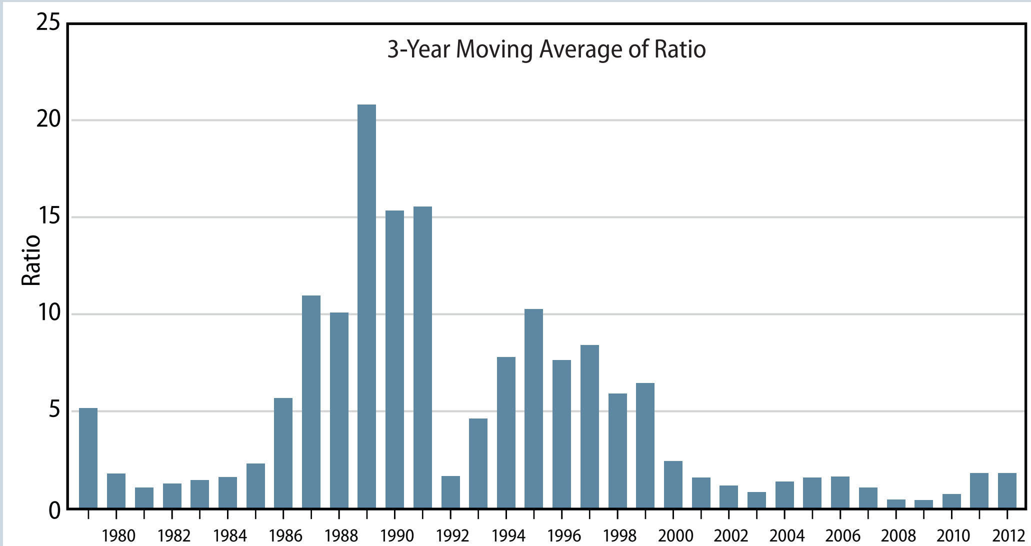
Standard guidelines for US core mandates from the early 1970s (arguably the start of the active bond management business) to the beginning of the financial crisis kept duration limitations tight. At a maximum, the usual constraint was limited to plus or minus one year either side of a benchmark's duration. The reason was that if a manager should take two years of duration risk and be on the wrong side of a 400-basis-point move, the program would be capsized by 8%. Interest rate moves were so violent that a 400-basis-point move would not be surprising. In 1980, short-term interest rates dropped by more than 1000 bps in the first half of the year, only to rebound over 1000 bps in the second half of the year. Intermediate rates (which are more representative of the duration of core assignments) moved less, but swings of several hundred bps were the norm in the 1970s and 1980s. Long rates, though less volatile, peaked when the Treasury auctioned the 15.75% 20-year bond in September of 1981. Given its much greater price volatility, being on the wrong side of a major interest-rate swing was deadly for performance.

As a consequence of these remarkable conditions, the major source of risk and arguably of return over this period came from interest rate, yield curve, and convexity management. The fixed-income firms that grew had to be exceptionally skilled at interest rate management. Indeed, virtually all of the heads of fixed-income firms had extremely strong rate backgrounds.

Compare this with the standard guidelines for investment-grade corporate bonds: they were silent. No restrictions were placed on percentages of aggregate holdings. Why? Yield spread volatility was so low. The investment-grade credit index just didn't move very much. Sure, you might be on the wrong side of a 25-basis-point widening in a weak economic environment and, if you had a full year of extra spread duration, this might impede performance (by 25 bps). So the P&L impact from spread volatility took a back seat to specific issue risk. Managers who took outsized individual name risk had to demonstrate bottom-up credit research capabilities. They were judged by whether they could select names while avoiding permanent capital impairment rather than on managing spread volatility risk.

The relative riskiness of adding a year of outright duration risk versus adding a year of spread duration in investment-grade credit is shown in Exhibit 3. In the 30 years preceding the crisis, interest-rate risk has swamped spread duration risk, clocking in at multiples of as many as 10 times during several stretches. In this environment, an intense concentration on interest-rate movements combined with a bottom-up research focus presented a complementary skill set reasonably well designed for the times. Success was predicated on being able to be on the right side of interest-rate moves while clearly controlling such risk and, to a lesser extent, earning a higher return through security selection and careful credit research.

Exhibit 3
Relative Riskiness* of Duration Bets vs. That of Credit Spread Bets



Source: Barclays, Western Asset. As of 31 Dec 12
**Tracking error against Barclays Aggregate induced by an extra year of duration as a multiple of the tracking error to the Aggregate from an extra year of spread duration.*

Back to the Future?

Compare and contrast this with the current environment, in which spread duration volatility swamps interest-rate movements. If an investor added a year of interest rate risk and was in what might now seem a substantial 50-basis-point adverse move, the loss was simply 50 bps. Spread duration has exhibited moves of several hundred bps over the last few years. The relative risk has completely inverted. Will this regime change persist? For now, such a possibility is supported by monetary policy that freezes short rates at zero for many years. But, ultimately, any sustained policy success will dampen the riskiness of credit while reawakening interest rate volatility.