

## Fixed Income Strategy Update and Outlook April 29th, 2011

### Reaching For Growth

Last week the Commerce Department reported U.S. Gross Domestic Product (GDP) growth for Q1 was 1.8 percent - below the 2.0 percent consensus forecast and measurably lower than the 3.1 percent rate posted for the prior quarter. Over the quarter surprisingly strong consumer spending was more than offset by a 5.2 percent in government purchases and a 4.1 percent fall in residential construction. The latest report supports our view that the U.S. economy will continue to forge ahead with steadily improving fundamentals but overall growth will be considerably less robust than the faster pace associated with previous post-recession rebounds. Despite the bumpy growth path ahead, bond owners will still need to be concerned about inflation with respect to rising commodity prices, but the deeply imbedded 'wage push' inflation feared by some central bankers and witnessed in prior inflationary eras is unlikely to materialize as job formation remains sluggish and the beleaguered housing market slowly grinds on. Consistently low bond yields on investment grade securities will tempt fixed income investors to move out the interest rate curve taking greater principal risk and often accepting a higher level of credit risk. Between the two necessary evils, we favor taking slightly more credit risk within the context of a slowly improving macro environment and the possibility of higher interest rates later in the year. Overall, selectivity and uncovering value will remain the keys to managing bond portfolios.

### **Slow Job Growth**

While inflation can be detrimental to an economic system, creating jobs is the key to a 'self sustaining recovery' which still holds center stage. Therefore, despite a rising chorus of 'hawkish' Fed members, job growth will ultimately take precedence over controlling inflation and QE2 will likely be completed in its entirety through the June 2011 target date. On the plus side, the latest jobs report surprised to the upside in terms of total jobs added - but it must be remembered that while the US economy has now created jobs for six consecutive months, the rate of job creation is much lower than that experienced in prior recoveries. For example, all of the jobs lost in the 1981 recession were replaced within 28 months of its end and within 31 months following the end of the 1990 recession. Since the start of the current recovery (officially beginning in June of 2009) 1.8 million jobs have been created. However, the U.S. is now 21 months into economic recovery and although data have moved in a positive direction these job gains represent only 21 percent of the 8.6 million jobs lost. Assuming a present rate of approximately 200 thousand new net non-farm payroll jobs per month, it will be at least another three years to gain back the lost jobs. The Fed's recognition of the employment challenge was apparent in last week's FOMC statement; the Fed decided to leave rates unchanged 'at these exceptionally low levels for an extended period of time' and further announced that the FOMC would be 'regularly reviewing the size and composition of its securities holdings and is prepared to adjust those holdings as needed to best foster maximum employment and price stability'.

### **Strategy**

Year-to-date credit sectors have outperformed government bond sectors with spreads tightening the most on financial services companies, energy and telecommunications issues and we expect this trend to continue into the summer months. Specifically, we are looking more closely at financial sector names as many of the higher grade industrials have narrowed substantially against the government yield curve. Duration should be kept short of benchmark for now but will be evaluated again towards the end of the QE2 program scheduled to be completed in June of this year. Selected Commercial Mortgage Backed Securities (CMBS) and Collateralized Mortgage Obligations (CMO's) are also offering value in addition to high quality. And finally, callable 'cushion paper' in either straight debt or preferred securities offering attractive spread will allow for extra yield pickup and relative price stability as we expect any interest rate rises on the long end to be accompanied by slightly tighter credit spreads. Furthermore, cushion bonds should keep the portfolio durations relatively short as the securities ultimately trade to the call prices and ride down the yield curve.

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