



# 1<sup>ST</sup> QUARTER 2010 OUTLOOK

## PRUDENTIAL FIXED INCOME MANAGEMENT

January 2010

### *2009: A Record-Setting End To a Tumultuous Decade in Fixed Income*

Given the deep gloom under which 2009 began, the year turned out to be notable for just how wrong it proved the pundits who had predicted the worst. The US economy didn't slip into depression, but rather, the Great Recession ended. Businesses didn't tumble wholesale into bankruptcy, but rather continued cost-cutting and deleveraging, resulting in record profits for some. Most large banks didn't go under, but instead got their fiscal houses in order, raising capital and even repaying their TARP loans. Consumers didn't remain under lockdown, but instead cautiously ventured back out to shopping venues, or at least to those offering good bargains. And, closest to home for us, the credit markets didn't cease to function, but instead, sensing the world was returning to "normal", turned in some of their best performances on record. Indeed, it was a blockbuster year for credit.

Speaking of credit, we owe a great measure of it to the US Government, particularly the Federal Reserve, and their aggressive policy actions throughout 2009. In our view, it was the comprehensive package of fiscal and monetary policy actions last year that successfully stabilized the US economy and markets at what was an unprecedented time in history. Government intervention may not always be welcome, but in 2009, it was exactly what was needed.

#### **Credit Markets Make A Comeback**

While the credit sectors surged in 2009, US Treasuries sagged. Yields on long-term US Treasuries, the global "flight to quality" choice in 2008, rose as newly confident investors left for more enticing options. The year in fixed income is shown in the table below:

**Fixed Income Performance by Market Sector  
2008 and 2009**

Total Returns	2008	2009
US Treasuries	+ 13.74	- 3.57
US Agencies	+ 9.26	+ 1.53
Mortgage-Backed (Agency MBS)	+ 8.34	+ 5.89
US Aggregate	+ 5.24	+ 5.93
US Corporate Bonds	- 4.94	+ 18.68
Commercial Mtg-Backed Securities	- 20.52	+ 28.45
Emerging Markets Debt	- 12.03	+ 29.82
US High Yield	- 26.16	+ 58.21

Source: Barclays Capital, Bloomberg, and JPMorgan. Indicates the performance of a representative index for each sector.

**2010: Expect more selective outperformance by spread product, mortgage underperformance, and higher short-term US Treasury yields, making for a higher, flatter US Treasury yield curve.**

#### **The Economy: Nice Momentum, But a Ways to Go**

We enter 2010 with accelerating economic growth both in the US and across much of the globe. Business and consumer sentiment improved as 2009 progressed, aided by the rebound in financial markets. A two-year stretch of job losses appears to be ending and household income has begun to rise modestly again. Government programs to stimulate auto sales and housing have spurred activity in both sectors. And, should the economy fail to gather sufficient steam in 2010, there is the possibility of a further stimulus package, such as the \$150 billion one that was narrowly passed by the House in mid-December.

So, despite still-present headwinds of high unemployment, high consumer debt, ongoing residential foreclosures, and an overhang of commercial real estate, the US economy appears to be carrying momentum into 2010.

#### **2010: Another Good Year for Spread Product, But With More Challenges Than 2009**

Continued high investor demand, improving credit fundamentals, and still-somewhat-above-average spreads bode well for the credit markets in 2010, although we are adding some qualifiers.

First, with credit spreads starting the year at much narrower levels, there is far less room for outperformance. Secondly, the markets may get jittery as the Fed begins to transition to less accommodative monetary policy. Third, sovereign risk will be an increasingly important concern, as governments of all stripes, from California to the US federal government to Greece and Italy come to terms with looming deficits. Finally, no longer will a rising tide lift all boats: expect investors to be far more discerning in 2010.

#### **Our Favorite Ideas: Money Center Banks, Higher Quality High Yield Issuers, and Some Structured Product**

We highlight inside some of our favorite ideas, such as money center banks, high quality high yield issuers, and select structured product. We also note some sectors where we see the risk as now greater than the reward.

## US GOVERNMENTS



In 4Q, and in 2009 overall, US Treasury yields rose steadily from historic lows, with intermediate- and long-term rates rising more than short-term rates. This disparate rise in yields led the yield curve to steepen significantly over 2009. US Treasuries were vulnerable for three reasons: 1) a shift in investor sentiment to higher yielding securities, 2) record new US Treasury issuance to finance the government's stimulus efforts, and 3) renewed fears of rising inflation as economic growth resumed.

US Agency debentures continued to outperform US Treasuries in 4Q. They were supported by moderating supply, continued demand from domestic real money accounts, and the Fed's ongoing purchase program.

In 2010, we expect a higher, flatter yield curve, as short and intermediate rates will likely rise if economic growth

picks up further. We believe longer-term rates will be more muted, supported by stronger demand, especially from pension funds. We hold a neutral view on US Agencies. They should continue to benefit from favorable technicals, although the Fed's purchase program ends in March. We are also neutral on Temporary Liquidity Guarantee Program (TLGP) debt, which is currently priced cheap vs. Agency debt. In the interest rate swap market, we expect wider spreads for longer maturities as investors move from (traditional) interest rate swaps to the new ultra long bond futures contract.

*Outlook: Expect modestly higher intermediate US Treasury rates. Neutral on Agencies relative to similar maturity US Treasuries.*

## MORTGAGES



Agency mortgage-backed securities continued to outperform US Treasuries, delivering +75 bps in excess return in 4Q and +495 bps for the year.

Throughout the year, mortgages benefited from the US Government's aggressive mortgage purchase programs. The Fed and US Treasury began purchasing newly-issued agency mortgage securities in early 2009 in an effort to lower mortgage rates and encourage new mortgage origination to homeowners. To date, the Fed has completed nearly \$1.11 trillion of its target \$1.25 trillion of open-market mortgage purchases. Actual mortgage lending to homeowners, however, remains well below projections. As a result, net new supply of mortgages has been low. That, coupled with lower prepayments, has provided price support for the mortgage security market.

At year-end, the US Government surprised investors by announcing it would provide significant new levels of

financial support to Fannie Mae and Freddie Mac. The US Treasury will now provide *unlimited* financial backing to both companies for the next three years, further aligning the companies' objectives with the Government's mortgage modification and residential foreclosure prevention programs. While the ultimate effects on the mortgage market are unknown, we expect prepayments to rise as delinquent mortgages are purchased out of mortgage pools.

Currently, we continue to hold a negative view on mortgages given rich valuation levels. Within the sector, we prefer 30-year fixed mortgages for their higher yields, as well as seasoned loans to limit extension risk. Higher coupon mortgages, which meaningfully outperformed in 2009, could be more vulnerable to increasing prepayments during 2010.

*Outlook: Negative, given rich valuation levels and more attractive spread product options.*

## STRUCTURED PRODUCT



The structured product market enjoyed a historic rally in 2009, with spreads narrowing dramatically. The rally moderated in 4Q, with spreads trading in range-bound to slightly tighter levels.

AAA rated CMBS spreads were generally range-bound in 4Q. Although the PPIP (Public-Private Investment Program) funds finally closed in 4Q, spreads had already compressed on advance buying, and there was little

further spread tightening. Overall, CMBS fundamentals still remain exceedingly weak. Delinquencies are rising amid growing evidence of aggressive loan underwriting. Yet, there are small signs of progress. A handful of new CMBS securitizations were originated in 4Q, a positive sign for commercial real estate financing. Property values, down an estimated 43% from peak levels, may have found a floor, with significant capital raised in 4Q for new commercial real estate ventures.

Next quarter, however, spreads could become volatile, as the TALF (Term Asset-Backed Securities Loan Facility) program is set to expire at the end of March. Currently, we continue to see value in well-researched, intermediate-term super-senior CMBS tranches with structural enhancements that still trade at wide spread levels over swaps (+275 bps to +375 bps.)

Non-agency residential mortgage spreads were also range-bound. Fundamentally, home prices have temporarily stabilized, although foreclosures and delinquencies continue to rise. Prices of existing securities remain at distressed levels and issuance of new securities is nominal. We continue to see significant value over the long term.

The ABS market continued to improve. Spreads on AAA rated credit card trusts closed at their lowest levels

of the year, as investors continued to bid high-quality, generic ABS securities well through the TALF financing rate. Fundamentally, credit cards remain weak, with charge-offs hovering near 10%, although issuers do have the ability to actively manage credit card terms. In fact, they have been actively re-pricing accounts ahead of new regulations that are scheduled to take effect in 2010. Auto ABS credit performance generally held up in 4Q, despite an uptick in defaults.

In today's market, we believe both AAA credit cards from top tier issuers and auto securities on the front-part of the curve offer attractive risk-adjusted returns.

*Outlook: Very positive. Spreads remain attractive for "top of the capital structure" bonds.*

## US AND EUROPEAN CORPORATE BONDS



**U**S investment grade corporate bonds closed 2009 on a strong note, delivering +307 bps in excess return over US Treasuries in 4Q and +2,276 bps year-to-date. Corporate bonds posted their strongest annual excess returns in history. US corporate spreads narrowed 383 bps during the year, closing at +172 bps. European corporate bonds also delivered exceptional returns, with spreads narrowing 286 bps for the year.

Stable-to-improving credit fundamentals and outsized investor demand drove the corporate market for much of the year. While massive government stimulus programs worked to prop up the fragile US and European economies, companies also took their own steps to shore up balance sheets and improve cash flow and productivity. The result was better-than-expected earnings for many firms. Companies in the building materials and paper industries generated the highest returns. The financial sector also began to heal, with many large banks issuing significant equity to increase capital positions and repay outstanding TARP funds.

New corporate issuance posted another record in 2009, with much of it being used to refinance outstanding issues, particularly shorter-term debt. This extended the

average maturity profile and reduced the liquidity risk of many investment grade issuers. Investors, hungry for yield, eagerly absorbed the new issuance.

Despite last year's rally, we believe corporate bonds remain attractive. The still-strong technical climate, gradually improving balance sheets, and growth-supportive government programs should promote further narrowing of spreads. Demand should remain healthy, as long as yields don't trend sharply lower. Longer-term debt, in particular, should remain well bid as companies prepare to meet the requirements of the Pension Protection Act.

As we enter 2010, we continue to overweight select BBB rated issues and financial issuers. In the US, we are adding selectively to cyclicals and REITS, and are overweighting longer-term, 30-year maturities. In Europe, we are currently overweighting lower-tier (LT2) subordinated debt, which we believe more than compensates for extension risk. We continue to take advantage of new issue concessions, when available. Concessions have fallen considerably, but still provide some value on lower quality and higher beta issuers.

*Outlook: Positive. Spreads should tighten as fundamentals improve and investors continue their "reach for yield."*

## LEVERAGED FINANCE



**T**he high yield rally moderated in 4Q, with spreads over similar maturity US Treasuries tightening 131 bps, and delivering a +6.2% total return. High yield bonds posted their best annual return *ever* in 2009, up +58%, as spreads narrowed a massive 1,068 bps. US and European bank loans also returned more than +50% in

2009, although they have started to lag high yield due to their lower coupons and high dollar prices.

Lower quality CCC rated bonds far outshone higher quality B and BB rated issues in 4Q and the year as a whole. Higher beta, more cyclical industries such as media, chemical, auto, retail, finance, technology, and even homebuilding companies

performed best, while defensive industries – utilities, cable, packaging, food and beverage, and telecommunications – lagged. New high yield issuance accelerated as the year progressed, on pace with growing demand levels from traditional retail and institutional investors, existing CLOs, and crossover investors hungry for yield.

The market's sharp improvement in liquidity has lowered the near-term default risk for many high yield companies that have financing needs. Most companies remain focused on free cash flow generation, debt reduction, and managing liquidity via reduced capital expenditure, inventory management, and in some cases, equity issuance. Credit fundamentals have stabilized or even improved in many sectors, with year-over-year comparisons expected to look good for the next several

quarters. Even so, a full recovery in revenues and earnings for most issuers is still years away, and many remain overleveraged. Should the recovery stall, lower quality credits are at risk of a setback.

From a technical standpoint, the high yield market remains well-supported, with continued sizeable inflows. We expect the high yield market to tighten as the reach for yield and improving fundamentals drive prices higher in 1Q. In this environment, we continue to focus on better quality high yield credits with solid asset coverage and strengthening financial prospects.

*Outlook: Cautiously optimistic. Security selection based on fundamental research remains critical as the market is still vulnerable. In some cases, the indiscriminate grab for beta has resulted in distressed credits becoming overvalued.*

## EMERGING MARKETS DEBT

Emerging market debt posted modestly positive returns in 4Q, capping off a strong year. Sovereign USD-denominated debt returned +1.6% in 4Q and +29.8% for the full year, the second highest performing year for the JPMorgan EMBI Global Diversified Index. Emerging markets corporate debt also rebounded, delivering a notable +41.7% for the year. Local debt (hedged to USD) trailed, returning just +5.2%, primarily due to concerns about interest rate hikes.

The strongest performers for the year were higher risk, higher yielding countries, such as Argentina, Venezuela, and Ukraine which rose between 60% to 130%. Countries with lower returns tended to be higher quality/low spread countries, such as Brazil, Chile, Malaysia, and China. In the FX markets, Brazilian, Indonesian, and South African currencies each appreciated 30% to 50% as emerging markets currencies continued to rebound from last year's slump.

Our outlook for emerging markets debt in 2010 is closely tied to the global macroeconomic outlook, which varies widely across regions and countries. In Asia, we expect growth of more than 8%, led by China, and driven by domestic demand and global trade. In Latin

America, strong commodity markets and domestic demand should lift growth to about 3.5%. In both regions, rate hikes are likely. In Eastern Europe, however, we expect growth to lag due to higher leverage, tight credit, and weak exports, leading to possible rate cuts.

Currently, we are focusing on higher yielding opportunities in lower quality sovereign debt and in undervalued distressed corporate debt. The global appetite for risk and issuer specific drivers support this investment thesis. There are select opportunities in higher quality sovereign USD-denominated issuers, although the sector as a whole appears fairly valued for now. We are also finding tactical trading opportunities in emerging markets currencies in higher yielding countries with strong growth prospects, such as Brazil, Turkey, Russia, and Indonesia. We will be keeping a close eye on global central bank policies and potential rate hikes, which may come as early as 1Q in some faster-growing countries. We would view any market correction as a buying opportunity.

*Outlook: Optimistic on select opportunities. Stronger global growth and demand for "high yielding" assets should support emerging markets debt. Key risks include premature removal of fiscal and monetary stimulus around the world and a sudden decline in investor risk appetite.*