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So Much For Goldilocks

As recent market events have unfolded, the REO Speedwagon hit "Ridin' the Storm Out" keeps popping into my head. What's fascinating about the current market environment is the extreme market reaction to the current economic slowdown. To me, the real surprise regarding the slowdown is how surprised the market seems to be! So much for Goldilocks!

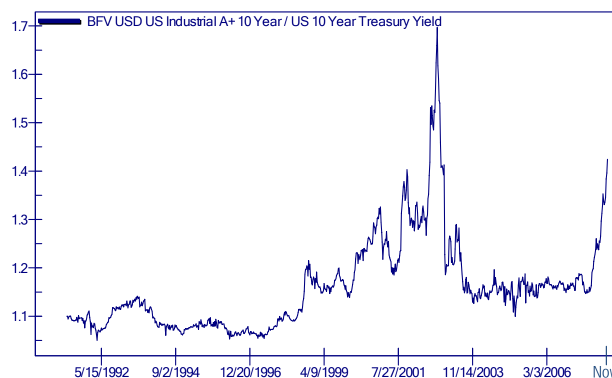
As I wrote in two previous investment letters entitled "What's in a Curve" dated January 2006 and "Help is On the Way!" dated October 2006, the yield curve (we'll reference the spread between the 3-month treasury yield and the 10-year treasury yield) has always reacted to Fed policy in a remarkably consistent pattern. When the Fed raises short-term interest rates significantly, like it did from June 2004 to June 2006, the yield curve tends to flatten and even inverts. Furthermore, the odds of an economic slowdown increase dramatically when the yield curve inverts. This is particularly true when it is inverted for an extended period of time. Thus, the slowdown should be no surprise after 10 months of yield curve inversion!

Also contributing to the economic slowdown are a weak housing market, high gasoline prices and a relatively high funds rate. Furthermore, the magnified effects of a weak housing market on the economy, due to the leverage inherent in many of the new structured mortgage and mortgage-like securities, have been additional negative economic influences.

In my October letter, we also described the yield curve work by our Quantitative Strategist, John Lohman. In a nutshell, he studied past Fed tightening cycles and their effect on the yield curve. This work helped guide us in the yield curve positioning of our fixed income portfolios. Since late 2006, we had virtually all of our portfolios positioned for a steeper yield curve. His work predicted the yield curve, as measured by the spread between the 3-month treasury yield and the 10-year treasury yield, would increase (steepen) by 105 basis points approximately 18 months after the last increase in short rates by the Fed. Since the last Fed increase was June 29, 2006, 18 months from then is roughly now. Amazingly, as predicted, the yield curve has steepened just over 110 basis points over this time period with much of the move coming the last 90 days. Thus, we have recently changed our portfolios and are now neutral on the yield curve for the first time since 2003.

Since our yield curve positioning has been such a great contributor to our outperformance the past several years, and now that we have moved to a neutral yield curve position, where do we add value for our clients from here? The answer is in spread product. We think today's spread levels, or extra yield over similar maturity treasuries, offer a rare opportunity for bond managers to begin moving marginally down the credit spectrum. In particular, we like adding yield to the portfolio by selling treasuries and agencies and purchasing intermediate high quality bank and brokerage corporates with over 225 basis points of extra yield over treasuries as well as agency 15-year mortgage securities with over 195 basis points of extra yield. We like these trades for two primary reasons:

The first is the excellent value the yield spreads offer as a ratio to the general level of today's rates. In other words, getting 225 basis points of extra yield when rates are 10% is one thing. Getting 225 basis points when rates are 4% is another. As an example, below is a chart that graphs the spread over treasuries earned by a 10-year A+-rated industrial corporate bond as a ratio to the 10-year treasury yield. The graph goes back to 1991. Today's levels are generally seen only during extreme market conditions like the post 9-11 environment.



Sources: Bloomberg, DHJA Research

The second is the generous breakeven levels of these yield spreads. Below is a breakeven chart for two different time horizons for the corporate and mortgage yield spread examples mentioned above. The breakeven levels that are bolded simply tell us how much yield cushion we have. In other words, the breakeven levels tell us how much the particular corporate or mortgage yield spread would have to widen (increase) over the horizon period before they would underperform treasuries. The breakevens are very attractive historically for such high quality securities.

Five-Year Breakeven Levels		
Horizon	MBS Spread—195 bps	Corp. Spread—225 bps
6 months	**24 bps**	**28 bps**
1 year	**55 bps**	**65 bps**

Today's rare opportunity exists because of the current fear in the marketplace and the fact that most managers are already overweighted in lower quality securities and have no choice but to "ride out the storm." But for us, we've started making our portfolio moves and have changed the dial. Now, I'm listening to Journey's "Don't Stop Believin'."

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