



Jeff Tjornehoj
Head of Americas Research
Lipper, Denver

Risky Assets Start the Year Where They Left Off—at the Top

Executive Summary

A bailout for Greece and a haircut for Greek bond investors took a lot of pressure off European regulators, and one might have thought it could crush the bond market. But the fact is, no one really believes Greece's problems have been resolved—only delayed for a little longer—and we may have upwards of three more debt issues to contend with in Portugal, Italy, and Spain before long. Yields on the benchmark bonds of Italy and Spain climbed 0.25% soon after the bailout-&-haircut package was announced, and even the new Greek ten-year bonds sold off in the week after the announcement, with yields rising to nearly 20%.

Recall that Italian ten-year bonds yielded more than 7% last quarter, which was the level reached by Greek debt when Greece finally had to plead for a bailout. But this quarter didn't progress so linearly; negotiations with Greek debt holders gave Italian bond holders confidence, and yields on Italian bonds declined to 4.84% in mid-March before climbing north of 5.00% again.

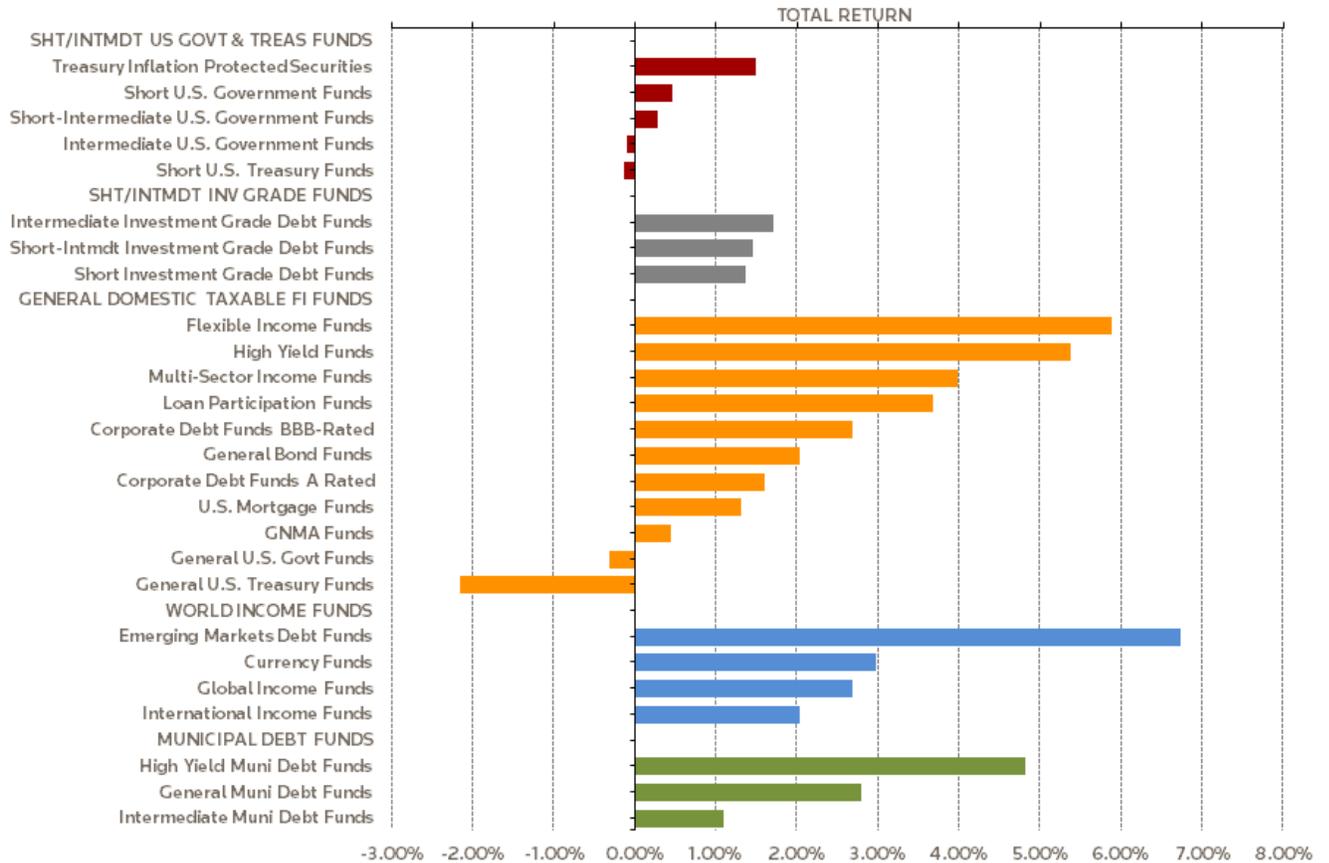
But Portugal has been a different story. It's already received a bailout package of some 78 billion euros, and investors are beginning to show some anxiety about how Lisbon will manage to roll over nearly \$13 billion in bonds that mature in September 2013. As this quarter ended Portugal's five-year note yielded almost 16%—well more than Portugal can afford—and put debt restructuring front and center once again.

Questions for the quarter ahead: will Portugal swallow its pride and approach the troika for fiscal assistance? Will the IMF engage Greece again soon after the second bailout to shore up its banks?

Still Got Treasuries?

- ▶ The General U.S. Treasury Funds group (-2.68%) was the clear loser for the quarter in a generally bond-friendly environment.
- ▶ A "risk-on" mentality changed the market sentiment and sent High Current Yield Funds up 5.42% and Loan Participation Funds up 3.72% for the quarter.
- ▶ The largest fixed income group, the \$766-billion Intermediate Investment-Grade Debt Funds category, was up 1.50% for the quarter.
- ▶ Munis largely shrugged off the problems facing Treasuries as Lipper's General Muni Debt Funds category gained 2.76% for Q1.

Figure 1 Fixed Income Fund Classification Returns, First Quarter 2012



Source: Lipper, a Thomson Reuters company

Treasury Funds Summary

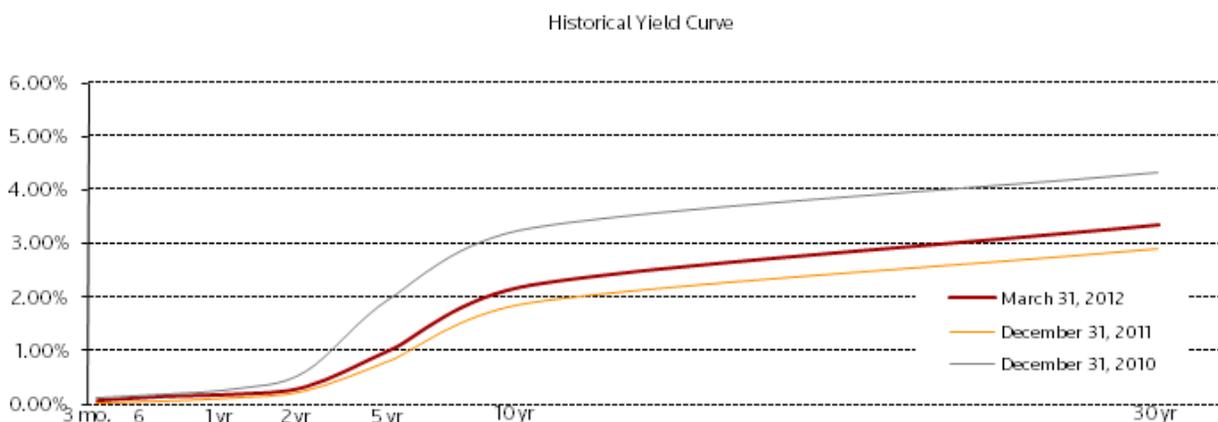
As the situation in Europe was allowed to move to the back burner of our collective minds for a bit, the flight-to-safety trade in Treasuries continued to fade away. March performance in Lipper's General U.S. Treasury Funds classification was among the worst (-1.68%) in the fixed income funds universe and contributed to its poor performance of 2.68% for the quarter. If this pattern sounds familiar, it is: both 2010 and 2011 began with risky assets in both fixed income and equity universes roaring ahead before a breather by investors turned into a sustained drop.

Treasuries gave up ground in the quarter on the back of a positive U.S. employment report and reduced expectations for further quantitative easing. If the economy was truly on the mend, the question arose of where rates might settle. If equity markets are any indication, ponder this: the last time the S&P 500 was at current quarter-end levels the yield on the ten-year note was considerably more than 4%.

Treasury Inflation-Protected Securities Funds, with a quarterly return of 1.21%, led all Treasury-related groups. In March the Treasury auctioned \$13 billion in ten-year TIPS at a record-low yield of -0.089%, which followed the first negative-yield sale for the ten-year note in January. The breakeven rate on ten-year notes was 2.38% at the end of March, well above the long-term average of 2.13%.

As shown in the chart below (Figure 2) the yield curve steepened over the quarter, although it continued to sit at historically low levels. The two-/ten-year spread widened from 164 basis points (which is historically typical) to 200 at mid-March and remained elevated at 190 basis points at the end of the quarter. The two/thirty spread, which narrowed under Operation Twist, started at 264 basis points in January and ended at 302, with a similar shift up at the middle and end of March. (Operation Twist runs through June 2012.)

Figure 2 Treasury Yield Curve



Source: U.S. Department of the Treasury

Corporate and Mortgage-Backed Bond Funds Summary

Corporate debt funds maintained the momentum they found last quarter and were led by the riskiest credits. High Yield Funds, with a return of 5.42%, stayed out in front. The lowest rated junk debt—CCC-rated paper—had the greatest jump in value with a return of 9.2%. In the U.S. high-yield bond issuance amounted to \$95.2 billion in the first quarter, far above the 3Q11 and 4Q11 totals. High yield credit spreads declined to roughly 460 basis points over Treasuries at the end of 1Q12—nearly a full point above their long-term historical average. At the same time Moody's lowered its estimate of the 12-month trailing default rate from 2.8% to 2.6%. In terms of spread activity the BofA Merrill Lynch US High Yield Master II Option-Adjusted Spread Index narrowed 132 basis points over the quarter.

Corporate Debt BBB-Rated Funds gained 2.38%, and the A-Rated group was up 1.34%. Both were outshined by the Loan Participation Funds group, which returned 3.72%. The loan market shot ahead strongly in January before settling down to return 0.77% for both February and March, according to the S&P/LSTA Leveraged Loan Index. The same strong earnings momentum that sent equity markets higher during the quarter was positive for corporate markets as well, and a lower overall supply of loans—coupled with decent flows from Loan Participation Funds investors—propped up returns also.

Mortgage paper was relatively strong for the quarter, thanks largely to the orderly selling of MBS paper by the Treasury Department over the past year. Recall that the Treasury bought \$225 billion in mortgages during the high point of the financial crisis and sold it off over the past year, reaping a \$25-billion profit for taxpayers as the program wound down mid-March. (The Treasury continues to support historically low mortgage rates through other means.) U.S. Mortgage Funds earned a 1.18% first quarter return, well above what was earned for the quarter by GNMA Funds (+0.36%). Mortgage bankers issued \$27.9 billion of GNMA MBS in February—below January's \$30.0 billion mark—maybe pointing to slower home sales.

World Income Funds Summary

The U.S. dollar index ended the quarter near where it began, at the 79.0-80.0 level. Currency Funds gained 3.18% on the quarter as many emerging-market currencies gained on the greenback. For example, the Turkish lira gained 7.5% on the quarter, and the Brazilian real was up as much as 9.8% against the dollar by February, before giving ground in March. However, German bunds continued to excel, with Treasuries now at a 48-basis-point premium over bunds. (Analysts predict that spread to go higher, perhaps to as much as 75 basis points in the coming quarter.) International Income Funds earned a 2.19% quarterly return but could not hold a candle to Emerging Markets Debt Funds, which gained 6.92% on renewed appetite for risk. In another sign of divergence between developed and developing economies, major equity benchmarks yielded more than sovereign debt in many developed nations such as the U.S. The reverse was true in emerging markets: local-currency bonds typically showed yields of about 6.3%—quite a bit better than dividend yields of 3.5% in Brazil and 3.0% in South Africa.

Municipal Debt Funds Summary

Muni debt continued to rally in 1Q12. The supply of new paper rebounded sharply in 2012 as year-to-date volume spiked to \$78.3 billion, compared to just \$47.9 billion in 1Q11, according to Thomson Reuters data. Municipalities were eager to float bonds in this low-rate environment, until yields backed up mid-March and refundings slowed way down. Among Lipper's single-state noninsured muni debt fund classifications California Muni Debt Funds, with a quarterly return of 3.41%, led; it was again followed by New Jersey Muni Debt Funds, with a return of 2.87% (both led returns in 4Q11 as well). High Yield Muni Debt Funds returned 4.78% as tobacco and airline debt improved, and the largest group—the \$116-billion General Muni Debt Funds group—advanced 2.76%. Among long-term noninsured categories the laggard for the quarter was Connecticut Muni Debt (+1.87%).

© Thomson Reuters 2012. All Rights Reserved. Lipper FundMarket Insight Reports are for informational purposes only, and do not constitute investment advice or an offer to sell or the solicitation of an offer to buy any security of any entity in any jurisdiction. No guarantee is made that the information in this report is accurate or complete and no warranties are made with regard to the results to be obtained from its use. In addition, Lipper, a Thomson Reuters company, will not be liable for any loss or damage resulting from information obtained from Lipper or any of its affiliates.