

Fall 2009

More Questions Than Answers

The US economy is recovering, but it is far from repaired. Elsewhere, particularly in “emerging Asia,” growth seems more robust. Asset markets appear to have priced in at least as much recovery as we see likely – perhaps more. Because so little appears cheap, we are pursuing a relatively cautious path.

Fixed Income: Not Much Short-Term Change

All types of corporate, agency, municipal, and asset-backed bonds have experienced spectacular rallies, while Treasury bonds have lost value during 2009. Earlier this year there were opportunities to take advantage of wide spreads to Treasuries, but those have ended. We think that current valuations for non-Treasury fixed-income securities are reasonable.

With the extreme concern about credit quality behind us, we don't expect to see much more narrowing in spreads. Coupon levels, however, remain attractive, and a slight overweight to credit is probably warranted.

The yield curve has been steep for some time now and is likely to remain so. We see little reason for the Fed to raise short-term rates over the next six months, and we expect that inflation expectations and supply worries will keep longer-term yields elevated.

Equities: A Defensive Posture

Sensible valuation indicators suggest that equities are now modestly overvalued, and certainly not cheap,

given the slow-growth environment that we expect over the next several years.

Modest overvaluation, however, does not rule out further market upside.

- Liquidity is abundant, and
- We anticipate a post-recession economic growth spurt of several quarters in the United States and perhaps longer in emerging markets.

Within equities, we seek to further overweight global high-quality companies.

- Valuations are reasonable for these “franchise” names.
- These companies should be able to thrive in an environment where competitors are struggling or ceasing operations.
- High-quality companies have substantial operations in the growing emerging markets of Asia.
- The core earnings strength of these companies also provides some downside protection.

Recent weakness in the US dollar has made US-based companies slightly more attractive than companies based elsewhere, so we have a slight overweight to US companies.

Emerging-markets valuations are highly sensitive to long-term growth assumptions, so it is difficult to make a clear call on valuation other than to say that

we feel confident that, at minimum, they are no longer obviously cheap and are probably overbought in the short term.

Real Assets: Inflation Not a Concern – for Now

Measured inflation remains subdued, while longer-term inflation expectations remain anchored around 3% or lower.

Because so little appears
cheap, we are pursuing a
relatively cautious path

Treasury inflation-protected securities (TIPS) have rallied. Much of the rally can be explained, however, by an unwinding of their huge underperformance relative to coupon Treasuries in the six months after the Lehman bankruptcy, when inflation expectations as measured by TIPS plummeted.

We are aware of the significant increase in the monetary base and are vigilantly watching for signs that money turnover (velocity) is picking up. To date it hasn't – and until it does we remain comfortable with an inflation outlook that is fairly neutral.

Commodities have been stronger than we expected, with global headliners such as crude oil and copper rallying powerfully relative to the dollar so far this year. We see little reason to be bullish on hard commodities over the next six months, but we do see slightly more value in global high-quality producing companies. We recommend exposure to natural resources equity positions.

US Dollar: Neutral vs. Major Currencies, Bearish vs. Emerging Markets

The US dollar has been under pressure since March, when the credit and equity rallies began in earnest.

- Because of ultra-low funding rates, the dollar has become a surrogate to the yen for funding cross-border speculation.
- Chatter (so far without action) from global central bankers about diversification of dollar-based reserves has put further pressure on the dollar.

- Fiscal worries exacerbate the pressure, including relatively subdued US growth forecasts relative to the rest of the world.

Despite what might appear to be “perfect storm” conditions, the dollar sell-off has been orderly. In reality, the dollar is about where it was in the winter of 2007, before the worst of the financial crisis hit.

At this point, we have no strong convictions on the dollar relative to the other major currencies. Relative to a basket of emerging markets currencies, however, we are slightly bearish on the dollar and recommend a position in short-term emerging market bonds of strong issuers.

This article is the collaborative effort of our investment committee.

Curmudgeon's Corner: A Desperate Craving for Yield

Last winter, when the stock market was hitting fresh lows on a daily basis, individual investors couldn't find the exits fast enough (you know who you are). The world was coming to an end – it was financial Armageddon. Some investors were dumping their high-yield bonds so far below par that the effective yield was greater than 20% – fleeing for the safety of Treasury bills yielding 0%!

Fortunately, financial catastrophe was averted and the world didn't end. In fact, it bottomed out with those capitulatory actions by investors in mid-March. Fast forward to December. We've just experienced a spectacular rally in stocks and corporate bonds. Because bonds have rallied, their yields have fallen precipitously.

So what are investors mostly asking me for right now? Most are asking for ... drum roll please ... **Y I E L D**.

Let's reiterate: When 20% yields were ripe for the picking, nobody wanted them. Now, when investment-grade bonds are yielding 3% and high-yield bonds are yielding about 7%, everyone is interested again.

I say to these clients, “Don’t you remember February and March. You didn’t want any risk in your portfolio?”

No ... they don’t remember. Here’s a sample conversation:

Client: Boy, are yields low.

Me: Yep, yields were much higher eight months ago when nobody was interested.

Client: My broker says I can beat the yield of CDs or munis if I invest in _____ (fill in the blank with high-yield bonds, preferreds, convertible bonds, leveraged loans, emerging market debt, Canadian oil trusts).

Me: Yes, you can get a higher yield, but these are all higher-risk investments. Three months ago you were probably asking for FDIC-insured CDs and now you want this stuff?

Client: I don’t know, you tell me.

Scarcer have become inquiries about “sensible” municipal bond ladders; more frequent are the inquiries about things like “a private CMBS deal a friend got into that yields 10%.”

These yield questions make me ponder something more fundamental: *In a low-yield environment, does it make sense to reach for yield?*

Should you ratchet up the risk to improve income? Obviously part of the answer is totally personal; it depends on how much risk you feel comfortable taking. But it also depends on how benign the market environment is. That’s not personal, and we can discuss it here. You need to look at both the absolute level of interest rates and the difference in yield between higher-risk investments and lower-risk investments (the spread).

To begin, let’s look at 10-year, credit-risk-free government bonds. Chart 1 highlights what you probably already know: Bond yields have been declining for the past 30 years. Currently, 10-year bonds yield about 3.4%. Back in the early 1980s, right before then-Fed chairman Paul Volcker launched his assault on inflation, you could have locked in 15% coupons for 10-year

Treasuries. Since then, due to a host of factors (mainly globalization and better monetary policy), inflation has all but gone away and bond yields have fallen.

Chart 1: U.S. Treasury 10-Year Note Yield

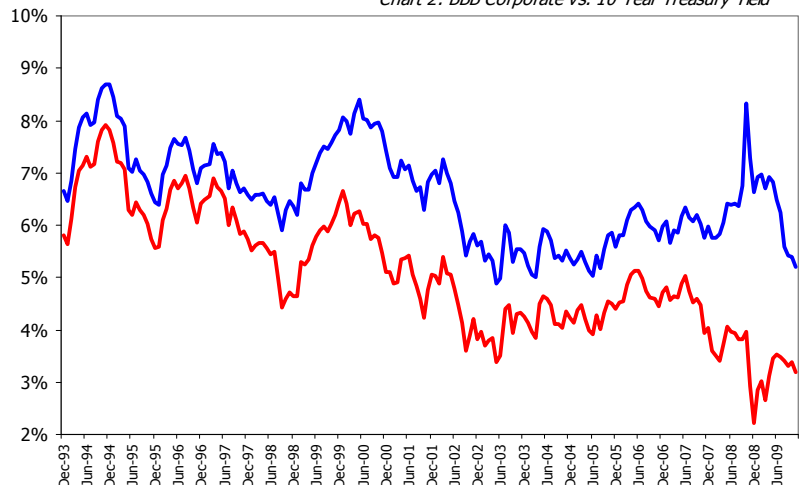


Source: Bloomberg, as of 12/7/09

So, yields are low and look as though they’re going to stay that way. Does that mean that it’s a good time to invest in riskier assets to improve yield?

Let’s look at corporate bond yields for clues. Corporate bonds yield more because they carry credit risk – the risk that the company will go bust (which can happen even to blue-chip companies like General Motors, as we have seen).

Chart 2: BBB Corporate vs. 10-Year Treasury Yield



Source: Bloomberg, as of 12/7/09

In Chart 2, we’ve added a line showing the yields of “triple-B” corporate bonds. BBB is the lowest rating a

bond can have and still be called “investment grade,” so triple-B yields offer a good indication of credit spreads and risk appetite. You can see that BBB-rated bonds *always* yield more than Treasuries. and the spread can be quite wide.

What can we learn from this chart?

First, we can see that triple-B spreads have fluctuated between about 5% and 9% during the past decade. Sometimes, as a bond trader might say, spreads are “tight to Treasuries” and sometimes they are “wide to Treasuries.” In 2004 and 2005, at the height of the credit boom, they were tight to Treasuries, but last spring they were very wide. By then, the flight to quality had caused Treasury prices to rise and yields to fall

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precipitously, while investment-grade corporate bond prices fell and their yields spiked to about 8%. For a brief period during our low-yield environment, you could have locked in 8% yields on investment-grade bonds. You can't any longer – yields are down to about 6%, and spreads have tightened substantially.

Second, we can see that spreads are, perhaps paradoxically, both volatile and persistent. They were tight for most of the middle part of this decade, but then blew out explosively with the credit crisis that began in the middle of 2007. Once they blew, they kept going, burying bottom feeders along the way. If you think this chart is scary, take a look at the charts for some of the riskier stuff that folks are beginning to ask us about again: closed-end funds, leveraged loans, high-yield bonds, CLOs and so forth.

So, should we sell our CDs and chase yield by buying BBB or even lower-rated and higher-yielding bonds – or maybe even mortgage-backed securities?

I'd say that for the longer-horizon investor, it's probably a push right now. Spreads look neither super cheap – heck, they were wider going into the turn of Y2K – nor downright rich. Spreads on triple-B bonds, at about 2.5% over Treasuries, are wider

than during the indiscriminate years of '04, '05, '06, and (most of) '07, but they've come in so much recently that you should tread cautiously.

We could pull out other charts as well. High-yield bonds look so-so at current levels, having narrowed significantly from record wides to Treasuries, and the same holds for preferreds and convertibles. REITS – yep, not so cheap. Closed-end funds – discounts to net asset value are almost gone *and* they use leverage, but there's some yield there.

So instead of opining on any particular category of “spread product” today, perhaps I can leave you all with a more lasting bit of wisdom.

Reaching for higher yields may make sense for you (or even me) based on a combination of your personal goals and an assessment of the market. But the real money is made when others are panicking, not after the all-clear has been sounded. Once *that* call has gone out, it's more of a crapshoot.

About the author: Perry Piazza is director of investment strategy, responsible for asset allocation and portfolio development. Previously, he held a number of trading-related roles in New York and London with Citigroup and Morgan Stanley. He earned an MBA from Yale and a BS from the University of Delaware.

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