

### *Fixed Income Returns in 2010 – Manage Your Expectations*

During the past two years, the investment grade bond market more than fulfilled its role as a source of relative stability during a period of extreme market turmoil. At year end 2008, the notion that stocks always outperform bonds over the long term was briefly violated when, for the first time in 60 years, the 20 year annualized return on large company stocks trailed that of long term Government bonds. At the start of 2009, with the financial crisis in full stride and economic conditions deteriorating sharply, yields on long term Treasury Bonds stood near their all time low of 2.5 percent. This reflected a near panic driven flight to quality. With improved financial conditions and the near certainty that the supply of Treasury debt is likely to grow substantially, investor appetite for Treasury securities has waned, pushing yields up by nearly 200 basis points in 2009. As a result, total returns on Treasury Bonds are set to be slightly negative in 2009 – the first negative annual return for Treasury Bonds since 1999. In a dramatic reversal from the previous year, however, corporate debt performed well in 2009, with the Merrill Lynch Corporate Master Index up over 20 percent through November compared with a dismal minus 7 percent in 2008. The broad investment grade universe, as a whole has performed admirably for the past three years with returns of approximately 7.1 percent, 6.2 percent and 7.1 percent, respectively in 2007, 2008 and through November, 2009.

With this backdrop, what can we expect from bonds going forward? In considering the prospect for bond market returns over the next 12-24 months we would note the following:

- 1) Despite the rise in Treasury yields, interest rates remain quite low by historical comparisons – especially in the short maturity range.
- 2) The Federal Reserve has pursued an unprecedented policy of monetary accommodation which, at some point, will be unwound.
- 3) As economic conditions improve, the relative appeal of alternative asset classes will likely increase.
- 4) The expected budget deficit during the coming years will require a surge in government borrowing and debt issuance.

Unlike 2009 when the rise in Treasury yields was more than offset by declines in corporate bond spreads, we would not expect yield spreads to compress significantly from current levels. We would, therefore, expect total returns from investment grade fixed income to be well below what we have been accustomed to in recent years. We would caution, however, that while the economy and financial markets have stepped backed from the abyss, their recovery is weak and they remain quite fragile and vulnerable to any unforeseen surprises. As such, equity returns are likely to remain volatile and may, in fact be vulnerable to a correction in 2010. In this environment we would argue that the case for fixed income as a key component of your portfolio remains solidly intact.

---