Brandywine GLOBAL

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Monthly Commentary /
Global Fixed Income

This overview of Fixed Interest investment markets for April 2011 is presented to AvSuper members.

Developed Global Bond Markets

Most global bond markets were able to shrug off the rise in commodity prices during April and rally modestly, although there were a few clear underperformers in the hard hit periphery of the Eurozone. Our sense is that high-quality government bonds were able to rally last month because global growth is slowing and it is unlikely that commodity prices will remain at such elevated levels if there is a further slowdown. The source of weakening growth is tighter monetary policy in the emerging world, the lagged effects of rising commodity prices, and also fiscal restraint brought on by a need to balance budgets in many developed countries. We are not expecting a global recession anytime soon, but we acknowledge the likelihood for further slowing and this is why we continue to run near or above-benchmark duration in our portfolios.

The best performing bond markets last month included the United States, the United Kingdom, and Mexico. The U.S. and U.K. bond markets are supported by domestic deleveraging pressures within the household sector. Rising savings rates and weak loan growth in these economies are diverting funds that previously would have been used for consumption or investment into government securities, thus holding down yields at levels below historical norms. Mexican bonds performed well on the back of continued good news regarding inflation (headline CPI was just 3.0% YoY in March), which has allowed the Mexican central bank to maintain its dovish stance. Even after last month's performance we still feel that Mexican bonds offer tremendous value with yields ranging from seven to eight percent along the long end of their government yield curve. The weakest performing markets, and the only countries to experience significantly negative returns during April, were peripheral EMU members including Greece, Ireland, Portugal and Spain. Financial markets have begun pricing-in a high probability of restructuring for Greek government bonds and this has spilled over into Ireland and Portugal.

Although Spanish bonds underperformed during April, Spanish yields remain well contained and recently Spain has been able to disassociate itself from EMU contagion. This has helped the euro to rally despite widening spreads in Greece, Portugal and Ireland. We remain underweight EMU bonds with a preference instead for high real yielding markets such as Australia, Mexico and South Africa. We also prefer to own U.S. and U.K. duration where we know that domestic deleveraging pressures are helping to hold down yields despite elevated issuance resulting from larger than usual budget deficits.

Currencies

The U.S. dollar continued its sell-off during April, especially after the U.S. Federal Reserve held its first ever press conference and used the opportunity to expound upon its plan for the upcoming end of quantitative easing. Chairman Bernanke laid out a fairly dovish path that would see the U.S. Fed stop expanding its balance sheet starting in July, but maintaining the balance sheet at June levels through the reinvestment of coupon payments. There was no indication as to when interest rates will finally be lifted, which probably means that such a move is still a long way off. That was certainly the reaction in foreign exchange markets and the U.S. dollar was sold across the board in the days following the press conference, taking it to extremely undervalued levels relative to most major currencies.

The best performing currencies last month were either commodity-linked or European. Commodities continued their ascent during April, albeit with growing divergence between various commodities, and this lifted currencies such as the Australian dollar (up 6.2%), New Zealand dollar (up 6.4%) and Norwegian krone (up 5.5%). European currencies are oftentimes viewed as "anti-dollars" and tend to do particularly well in a negative dollar environment. This was true last month and the rate hike from the European Central Bank also helped. The Swiss franc rallied 6.2%, the Swedish krona gained 4.7%, and the euro rose 4.6%. There were no major currencies that declined against the US dollar in April. Despite its weak performance last month, we continue to hold an overweight position in the US dollar for a number of reasons. First, valuation is extremely compelling at current levels and historically it has been unwise to maintain an underweight position against such stretched prices and negative sentiment. Secondly, we believe that commodities are at risk of a sharp correction and such a development would be a positive for the US dollar from a terms of trade standpoint. Lastly, we expect that the end of QE2 will be supportive for the dollar since the Fed balance sheet will no longer be expanding and there will be less USD liquidity provided to the markets. Only time will tell of course, but we feel the prudent course of action for the time being is to hold an overweight position in the US dollar.

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Corporate Bonds

U.S. corporate bonds performed well in April with both investment-grade and high-yield spreads narrowing modestly. This spread narrowing, on top of a slight rally in U.S. Treasury securities, created a respectable month of absolute returns for U.S. corporate bonds. In summary, A-rated 10-year U.S. corporate bond spreads narrowed 5 basis points (bps) to 144bps over 10-year U.S. Treasury securities.

Meanwhile, B-rated 10-year U.S. corporate bond spreads narrowed 10bps and ended the month at 449bps over 10-year U.S. Treasury securities. We continue to hold an overweight position in this sector due to the strong fundamentals within corporate America, our positive view on global growth for 2011, and also the attractiveness of the incremental yield that corporate bonds currently offer.

However, we have been winding down our exposure to this sector by selectively taking profits as our holdings reach or exceed our estimates of fair value. We expect this to continue.

Mortgage Bonds

The main focus of the non-agency mortgage market was on the weekly Maiden Lane II lists. The first list traded strongly with the following ones trading less strong, but still at decent levels. In the Prime and Alt-A market, trading volumes picked up during the month.

Non-Maiden Lane II supply mainly originated from proprietary desks and banks following Moody‘s downgrade of seasoned prime deals.

Cleaner bonds continued to trade at tighter spreads and dented bonds were flat. Due to persistent downgrade risk, we made decisions to gradually exit CMO positions for all investment-grade accounts.

Emerging Markets

Emerging markets assets benefited from the strong risk taking appetite that was evident in financial markets during April. Low U.S. interest rates continued to drive a reach for yield among investors and the weak U.S. dollar also helped to buoy most emerging markets currencies. An additional factor last month was the continued rise in commodity prices, which led to an increased tolerance for currency strength by many emerging markets central banks. A stronger currency helps to dampen import price pressures and the tactic of an appreciating currency has been co-opted as part of the inflation fighting toolkit in many countries. This was particularly true in China last month where the renminbi’s pace of appreciation quickened noticeably. Our emerging markets holdings performed well during April.

With respect to our bond holdings, Brazilian 10-year yields fell 34bps to 12.64%, which is still an extremely attractive yield in both real and nominal terms. Indonesian 10-year bonds had a very strong month too and 10-year yields there dropped 36bps to 7.68%. Finally, in Hungary 10-year yields were more stable, but still managed to fall by 14bps to end April at 7.05%. Our emerging markets currencies augmented these bond returns last month as well. The Brazilian real rallied 3.6%, the Indonesian rupiah gained 1.7%, the Hungarian forint surged 5.2%, and finally the Turkish lira rose 1.6%. We are comfortable with our emerging markets bond holdings at the moment, but we are watching inflation pressures in each of these countries very closely. We are more concerned with some of our emerging markets currency exposure, however, due to the strong rallies that many of these currencies have experienced in recent months and also due to the undervalued nature of the U.S. dollar in general, it is possible that we will move to hedge some of our existing EM currency exposure soon.