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FIXED INCOME STRATEGIES GROUP

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## Dislocated Expectations

As far as performance is concerned, it is safe to say Treasury securities have fallen flat throughout the midway point of the calendar year. On a total return basis, in fact, Treasuries (as an asset class) are posting an annualized loss of 8.84 percent through the first six months of the year – the worst start to the year over the last three decades.

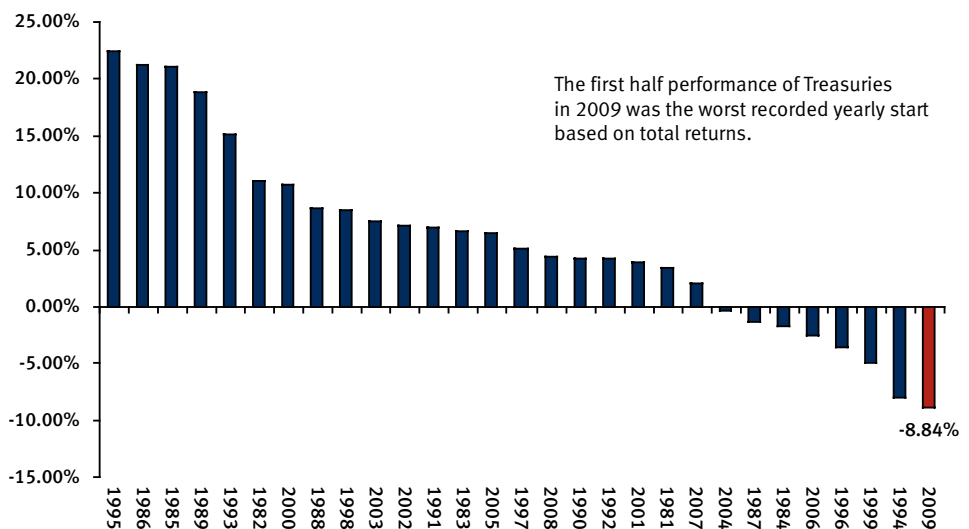
The results, though, are neither all that surprising nor without merit. After all, the very same index had gained more than 38.00 percent on an annualized basis during the three-month period ending 2008, pushed higher by demand for the high quality, fixed income asset class. Much like then, today the crux of the argument remains how to balance inflationary expectations with deflationary realities, leaving a tidal wave of volatility in its wake.

## A Return Beyond Normal

Given the dramatic extent of the market move, the year-to-date performance of Treasuries, in general, appears to be a natural consequence of their recent

### Starts to the Year 1981-present

Six-Month Annualized Treasury Total Returns beginning on January 1st



The first half performance of Treasuries in 2009 was the worst recorded yearly start based on total returns.

Data source: CitiMarkets, the Yield Book Treasury Index  
Chart by the Fixed Income Strategist Group, RBC Wealth Management

wave of popularity and not the outcome of any perceived shift in economic fundamentals. Yet, because of the actions of the Government and the Federal Reserve with respect to debt-engineered stimulus packages, we believe many investors are again sidestepping current realities with expectations that, ironically, supplant any recent inflationary forecasts.

Despite being just two quarters past a period in which the Consumer Price Index fell more than 13.0 percent quarterly annualized – five full standard deviations below its 60-year empirical mean – general consensus of market forecasts remains steadfast in its outlook that hyperinflation will plague the domestic economy for years to come. (Although the economy itself remains less than convinced.) This battle between conventional wisdom and common sense, therefore, will likely only add to the volatility that has already pot-marked what was once a more placid market since the beginning of the decade.

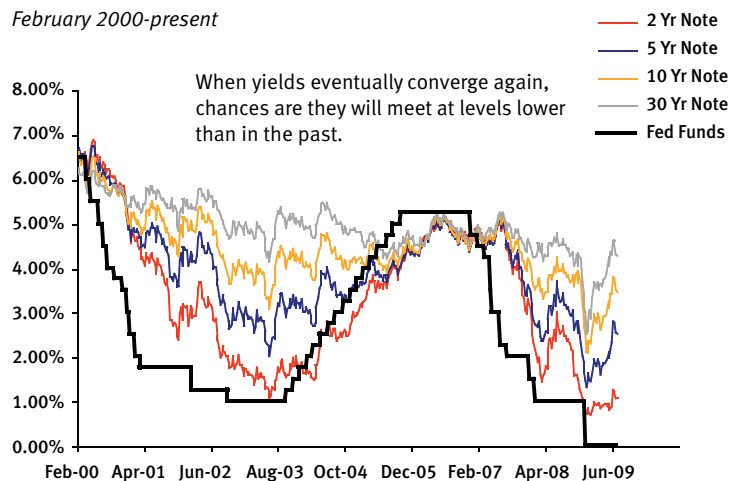
Normally one of the more subtle nuances within the realm of investments, the frequency and timeliness of Treasury yield movements have garnered a tremendous amount of attention as of late. Whether because of the Government's continual reliance on issuing debt to support current expenditures or because of the Federal Reserve's various term lending facilities (i.e. balance sheet expansion), the renewed interest in rate movements seems to stem from the desire to confirm any inflationary consequences resulting from manipulation of the money supply.

## Price (In) Stability

Although yet to come to fruition, waiting for inflation expectations to transform into concrete, sustainable upward price pressures is a popular pastime for many economists and financial analysts alike. Case in point, it was the Federal Reserve itself that solely based the latter half of its most recent Fed Funds tightening cycle on the fear that monetary policy was encouraging an environment in which inflation expectation could become “unanchored.” So prevalent was the argument, that the Fed's overnight rate at the peak of the cycle was three-quarters of a percent higher than that of the market-driven yield on the 30-year Bond!

## Benchmark (Government) Treasury Note and Bond Yields and Fed Funds

February 2000-present



Data source: Bloomberg L.P.

Chart by the Fixed Income Strategist Group, RBC Wealth Management

Today's argument, subsequently, centers on the unprecedented nominal amount of liquidity being introduced into the financial system after the deleveraging effects of the Fed's tightening cycle. Although clearly a different set of circumstances, the results of waiting for inflation are nevertheless likely to remain the same. More importantly, we believe it is policy's future impact on the macro economic price environment that will ultimately have greater repercussions on the investment community.

Analogous to missing the forest through the trees, it is the gradual erosion of price stability that is likely the largest opportunity cost of the stimulus packages to date, not inflationary consequences, as the former has the potential to alter the landscape of the domestic economy years down the road. And while any spike in the overall supply of money may indeed materialize in a “crowding out” effect (that is a rise in interest rates in an artificial fashion that ultimately crowds out private investment), we believe it will be more than overshadowed by the corresponding growth in under-utilized economic potential.

## Introducing Deflation

The further inability of the economy to operate within an acceptable degree of its potential should continue to pressure the “output gap” wider – the same dynamic, not coincidentally, that shaped the latest pocket of deflation

and illiquidity that has defined the past couple of years. The supply of the economy's unused capacity, and the potential that lies therein for future output growth, will likely keep anything resembling long-term inflationary pressures limited to a grossly unsustainable period of reflation.

Even though it may not appear so on the surface, great strides have already been made with regard to the current price direction debate. Already, most economists are conceding the fact that forces are likely to dominate "for just a couple of years" in the near-term before succumbing to the inflationary pressures they believe are basically unavoidable.

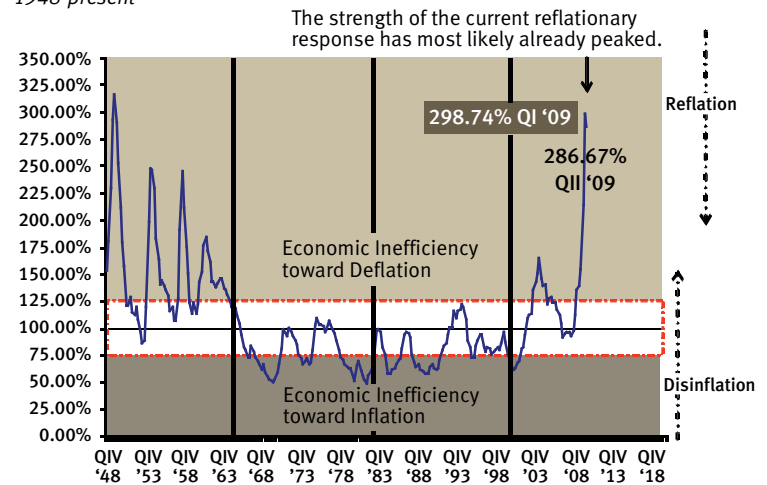
While this may not seem like a rather strong argument for the continued development of pockets of deflation, it becomes more significant when paired with the thought that this very same consensus led to an "it can't happen here" stance regarding deflation just two years ago. It should not come as a surprise, then, that economic indicators reflect an economy deeply mired in an environment more biased toward deflationary inefficiencies than inflationary ones.

The prospect of deflation draws a rather ominous response from the investing public. But it's not the prospect of falling prices that causes the most concern. It is the idea that deflation usually follows a spiral pattern. We believe this negative feedback loop is grossly over-exaggerated, though, and today's dynamics are not unlike the pockets of inflation experienced throughout the mid-sixties and the entire seventies. Whereas the inflation that developed over that timeframe was the result of an overheating economy with a narrow output gap, today's deflation is likely being caused by an abundance of economic potential which is creating too wide of an output gap. As a result, much in the same way inflation was disregarded as a longer-term threat back then, deflation still receives too little respect from today's fixed income investors.

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## Unemployment/Long-Term Interest Rate Ratio

1948-present



Data source: Bloomberg L.P.

Chart by the Fixed Income Strategist Group, RBC Wealth Management

## Taking Advantage of the Opportunities – the Solution Set

Fixed income investors generally need to strictly adhere to a stability-first approach to their portfolios. The first major consideration that is necessary to effectively accomplish that goal, consequently, is an appropriate amount of maturity diversification. While an investor doesn't want to be too long, a potentially bigger mistake would be to be too short. Exposing a portfolio to as many areas of the maturity curve as possible could go a long way in achieving a successful hedge against interest rate volatility. At the same time, though, investors would be remiss to sacrifice credit quality as a result. In fact, a combination of longer maturities and higher credits should continue to serve a portfolio well, just as it has century to date. Although a relatively simple plan in theory, it is hard to implement as it runs contrary to the natural inclination to be very defensive. As has been the case throughout history however, playing the contrarian may provide long-term benefits. We think that now is such a time.

## SOLUTION SET

### PORTFOLIO STRUCTURE

*It is imperative to remain as high on the capital structure and credit rating scale as possible. Meanwhile, for a majority of fixed income investors, maturity diversification translates into going out on the longer end of the curve and utilizing the asset classes highlighted at right.*



*It is imperative to remain as high on the capital structure and credit rating scale as possible.*

## SPECIFIC AREAS OF INTEREST

**GNMA Pools** — Provide monthly income and principal repayment, direct obligation of the U.S. Government. Based on current interest rates, 4.50% coupons may offer the most stability in this environment. Higher coupons, 5-5.50%, could potentially provide higher current cashflow and a cushioning effect in volatile market conditions.

**High Grade Corps** — Generally suited to operate within a deflationary environment. Market leaders with double and triple-A ratings should likely remain the focus despite spreads to Treasury counterparts that might appear tight on a nominal level. Discounted coupons, while limited in availability, may provide capital appreciation possibilities. Higher coupon, premium issues could provide higher cashflow and a cushioning effect from volatile market conditions.

**Munis** - Although subject to liquidity issues, and therefore volatility, buy and hold investors should benefit from the normalization of risk/reward scenarios. General Obligation (GOs) and/or Essential Purpose Revenues (Sewer and Water issues) could be considered. The taxable Build America Bonds (BABs) have reinvigorated the taxable muni bond market. They provide the opportunity for investors to extend out on the curve with high quality instruments whose yields can be higher than corporate bonds with comparable ratings.

**Bullet Agencies** - The lack of a call option increases the amount of “knowns,” in this case, a typically steady cashflow. Additionally, the current conservatorship status of issuers such as Freddie Mac and Fannie Mae are seen as generally offering another layer of credit support.

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