



Great Lakes Advisors, LLC
Fixed Income
3Q11 Commentary

The **European Union** is being severely tested, with both ends of the seventeen country spectrum at risk. Outlier scenarios include Greece getting the boot and/or Germany deciding that it would be better off on its own. And, as much as Greece is at the forefront of the EU's current problems, the reality is that the country is insolvent and that the primary focus should be on the financial health of the next countries in line and the banking system. The credit ratings of Italy and Spain were just downgraded, evidence of the threat of contagion. The European Central Bank has resumed buying government bonds of the more troubled countries, and it is only a matter of time before it reverses its recent interest rate hike.

The **EU's banks** have also been downgraded due to sovereign debt holdings. French and German banks have particularly high exposures to Italian and Spanish debt in addition to their exposures to Greece. Much as the Fed did in this country in 2008, the ECB needs to ensure that the banking system will survive and function in the event of a liquidity crisis. Also, the European Financial Stability Facility needs to be expanded such that emergency funding can be passed along to the region's banks. Finally, the earlier stress testing of European banks needs to be redone with heightened criteria.

Stock markets around the globe plummeted in the third quarter amid the concerns about Europe and declining worldwide economic growth rates. The S&P 500 fell almost 14% and is down over 8 ½% year-to-date. Europe's numbers were worse, down over 16% in the quarter and 15% for the first nine months. Asian markets have priced in the chances of a global downturn even more fully, off roughly 18% for both time periods. And, the Hang Seng Index, a proxy for China, dropped 21%, also for both periods.

The consensus view regarding the **U.S. economy** is that the recovery is losing steam, with only a negligible bit of growth expected for the fourth quarter. Third quarter earnings reports are anticipated to reflect the lowest increases in the last two years. U.S. companies are in relatively good shape given the environment, but profitability improvement is still more attributable to operational efficiencies versus top line revenue growth. Persistently high unemployment levels are a drag on recovery prospects, and the unrelenting housing decline similarly limits progress. The banking industry also remains a soft spot, as earnings are hindered by the painfully slow workout of bad home mortgage loans, an uninspired lending dynamic, a flatter yield curve and the need and desire to retain more capital.

Throughout these difficult times, the **Federal Reserve** has continued to be a good citizen and to provide help as needed. The most recent initiative is the implementation of Operation Twist. This will involve the Fed selling a total of \$400 billion of short-term Treasury maturities from its portfolio and using the proceeds to purchase longer Treasury maturities. The result will hopefully be lower long-term interest rates, which should in turn create more borrowing and investment. The Fed has also decided to reinvest the interest and principal flows from its mortgage-backed holdings back into the



government agency mortgage-backed market. Beyond these efforts, Chairman Bernanke is doing his best to impress upon lawmakers that the Fed's actions have their limits, and that meaningful progress in Washington is mandatory for economic improvement and long-term financial stability.

As the **housing market** was the original trigger to the Great Recession, it will also prove to be elemental to any lasting recovery. Housing prices are down 38% over the last five years and show no signs of turning around. And, as much as falling long-term interest rates have driven mortgage rates to historic lows, underwater mortgages are a huge constraint to refinancing activity. One in five mortgages has a balance larger than its underlying home's value, with total nationwide negative equity at \$750 billion. Principal reduction and loan modification programs have been largely ineffective. Finally, the possibility of a blanket refinancing to a much lower average mortgage rate remains low. But as other attempted solutions fall by the wayside, the idea is still on the radar.

There were precipitous declines in **interest rates** in the third quarter. The ten-year Treasury maturity dropped 125 basis points (1.25%) to close at a yield-to-maturity of 1.92%. Thirty-year yields fell even further, down 145 basis points to 2.91%. Yield falloffs were proportionately lower down the curve, with the two-year Treasury off twenty one basis points to end the quarter at 0.24%. Ultra-short rates cannot go any lower, as money market rates remain in the low single digits. In total, the yield curve shed a great deal of its historic cheapness. And, in general, the third quarter represented the bulk of interest rate movement year-to-date.

Fear-filled environments cause a flight from riskier to safer assets, and this was certainly the case for the **bond market** in the third quarter. Higher quality bonds outperformed lower quality ones, with the Treasury sector being the overwhelming choice and performance leader. And with rates lower in general, longer maturities posted the best returns across the maturity spectrum. As in the stock market, volatility increased greatly in the quarter for bonds as well.

The risk-off mentality reached the capitulation stage as the third quarter came to a close. Non-government **sectors** saw heavy selling pressure resulting in significantly wider yield spreads and reduced liquidity. This hurt the relative performance of spread sector allocations, but generally reinforced their standing as longer-term holds. Corporate bonds were some of the hardest hit, with bank paper experiencing the most pain. Mortgage-backed securities also underperformed comparable Treasuries, with lower coupons showing better than higher coupons. The commercial mortgage-backed sector is also in the midst of a serious slump after strong performance earlier in the year.