

Reality appears to have set in during the fourth quarter of 2008. Financial markets reacted violently to the fallout from the death of Lehman Brothers, near deaths of other financial institutions and the economic shock waves from the unfolding credit crunch. In fact, it would be hard to overstate the number and/or magnitude of “unprecedented” events witnessed in the past thirteen weeks, let alone the past year. All the while, despite aggressive monetary easing and massive direct government support for financial markets and various institutions, investors’ outlooks darkened amid a breathtakingly sharp deceleration in global economic activity. As if to accentuate the obvious, it was officially declared recently that the current U.S. recession actually began in late 2007, far earlier than most forecasters had suggested.

In a classic flight to quality trade, risky assets like equities and high yield corporate bonds fell hard during the quarter. Investors flocked to the relative safety of government backed securities, despite historically low yields. Yields on U.S. Treasury notes declined eighty to one hundred sixty basis points, depending on maturity during the quarter. Inflation fears receded on the back of crumbling energy and commodity prices, and a declining Federal Funds rate. In December, the Federal Reserve officially acknowledged a shift in monetary policy from interest rate targeting to “quantitative easing.” This in an effort to combat mounting deflationary forces, after having lowered short term target rates effectively to zero.

On the positive side, short term markets have demonstrated meaningful signs of improvement, especially over the critical year end period. Primary corporate bond issuance has resumed, with the new FDIC backed deals being very well received. Central bank programs designed to grease the wheels of the system, allowing credit to flow again appear to be working, albeit slowly. Notwithstanding these improvements and a modest rally into the waning days of the year, valuations across the fixed income landscape exited 2008 at exceedingly stressed levels. In some sectors, prices arguably still reflect a fundamental environment as bad as or worse than the Great Depression.

Exposure to non-Treasury sectors impacted performance negatively during the fourth quarter. While true for all of 2008 as well, this pattern was more acutely felt in the fourth quarter. Quite literally, there was almost nowhere to hide. Severe spread widening caused virtually all credit sensitive segments of the bond market to underperform. Lower quality corporate, non-agency backed mortgage and



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commercial mortgage securities were particularly weak during the period, reflecting their sensitivity to deteriorating economic fundamentals. Unfortunately, even small portfolio overweights to sectors afflicted by historically large return dislocations, resulted in significant performance drag vis-à-vis the market benchmark.

The list of concerns has rarely been more daunting in most portfolio managers careers: the scope of the credit crisis continues to expand, having been under-appreciated and under-estimated by market observers all along the way; economic activity around the globe is now contracting meaningfully in response; the possibility for a deflationary spiral to take hold is real; the efficacy of massive “unconventional” monetary policy aimed at averting financial disaster and reversing this financial mess is uncertain; the ultimate need to withdraw all the stimulus without sparking inflation on the other side lingers, as tomorrows problem; and of course, the ultimate cost to companies, markets, investors, taxpayers and future generations, will be staggering.

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So as we transition to a New Year, the domestic economy is entering a deep and potentially prolonged slowdown. Corporate earnings will be weak for some time. Default rates are beginning to rise. Residential and increasingly commercial real estate markets continue to deteriorate. Uncertainty, and therefore volatility will remain high.

If there is a silver lining to any of this, it is that pricing for most fixed income market sectors now more accurately discounts the reality of the current cloudy situation, and then some. What's more, a good percentage of the high quality investable bond market now enjoys some form of federal government support, direct or otherwise, lending valuable credit enhancement to investors. Other unique opportunities such as this exist in the current environment, many with historically generous yields. Given this yield cushion, we expect most – though not all – of these investments to perform well, even if broad markets trade sideways or weaken a bit in 2009 due to further economic distress.

History and current valuations suggest that a repeat of the horrific performance seen in many bond sectors during 2008 is unlikely. While we expect the broader environment to remain challenging for most of the year, attractive opportunities are available as we begin to think about positioning for the eventual recovery.

Conventional wisdom tells us that markets will anticipate a recovery long before it becomes evident in the financial press. The trade for 2009 will be about timing. Unfortunately, the risk of being early here is quite high, so we will tread cautiously. A bias toward actively improving liquidity both at the security and the total portfolio level is still warranted.

We remain overweight corporate credit in the investment grade, and to a lesser extent the high yield space, focusing on solid names in economically defensive sectors, and those enjoying government credit support. The agency pass through sector is another example of one which has real government support, with attractive yields. Liquidity here tends to be very good as well, allowing us to tactically trade this sector around temporary market dislocations. Conversely, nominal Treasuries are a portfolio underweight, holding little attraction for us at current low yields.

Lastly, we continue to search for low cost, high convexity ideas, meaning the upside payoff if we are right is substantially more than the downside if we are wrong. Treasury Inflation Protected Securities (TIPS) and convertibles are two examples of securities with this favorable risk/return skew. TIPS benefit from a structural coupon floor with unlimited upside should inflation reemerge. Similarly, converts trade like bonds in the current environment, but have the upside of a stock if/when equity markets recover.

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