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Fixed Income Research Update Rates Roundup: First Quarter 2010

Fed Commentary

We believe that the Fed dialogue and actions this quarter are consistent with our view that the Fed is on hold until Q4 2010 or Q1 2011. While the Fed has indicated a desire to move towards “normalcy,” we do not believe that this means they are in a hurry to raise rates.

Actions

- The FOMC met twice in the quarter and kept rates unchanged.
- The Fed confirmed the ending of the asset purchase program and swap lines and concluded the final TALF auction.
- The discount rate was raised to 0.75%, i.e. a spread of 0.50% over Fed Funds. This is less than the traditional 1% margin. The hike was done off meeting to drive home the point it was not related to monetary policy.
- Discount window lending was shortened to overnight from 90 days.
- Supplementary Finance Program (SFP)¹ bills were brought back in order to drain liquidity.

Verbiage

- Maintained the “exceptionally low” for an “extended period” language on both FOMC statements.
- Kansas City President Hoenig dissented at both meetings, citing the language as limiting Fed options going forward.
- Presidents Bullard (St. Louis) and Evans (Chicago) echoed the New York President Dudley’s previous statement that any change in the language would precede Fed action by six months or “three or four meetings”.
- Fed speeches focused on the labor market, commenting that the expectation is for it to remain “uncomfortably high” this year and next.
- Inflation is expected to remain subdued due to a large “output gap.”

¹ Under SFP, the Treasury Department sells T-Bills and places the funds on deposit at the Fed, effectively “draining” private sector reserves.

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Exit Plan

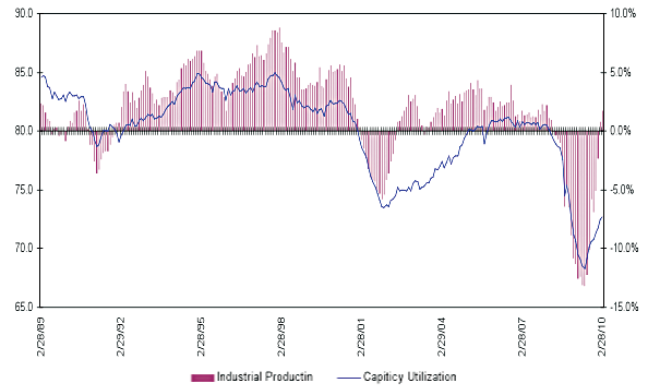
- Expand the use of reverse repos and the Term Deposit facility (6 month CDs) to drain excess reserves. While reverse repo lines are now only set up with the Street, the Fed is working on establishing lines with the largest money market funds.
- Continue SFP.
- Pay on reserves, i.e. bid reserves away from the private sector.
- Hike rates and sell assets.
- There was more discussion on asset sales as the quarter went on. Some members would like to sell sooner rather than later.

All the above points to the Fed on hold, anchoring the front end of the curve and re-enforcing our preference for a bulleted carry approach towards constructing fixed income portfolios.

Fed Expectations

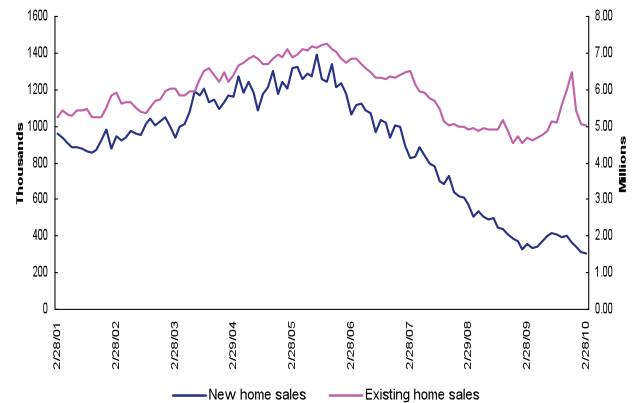
The Fed is expecting 2.75%-3.5% GDP growth this year and 3.5-4.5% next. The most optimistic Street view is 3.5%-4.0% this year. A growth rate of 3.0-3.5% has traditionally been viewed as the “speed limit” which holds capacity utilization constant. The data confirms an economy growing in fits and starts. While manufacturing has seen growth (in part due to an inventory build), housing and the jobs market continues to languish:

Capacity Utilization and Industrial Production



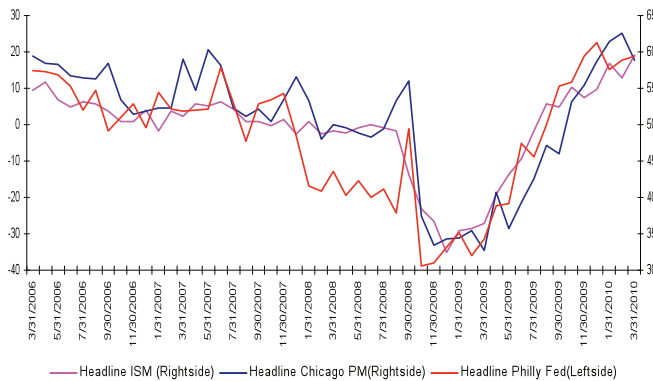
Source: Bloomberg

New & Existing Home Sales



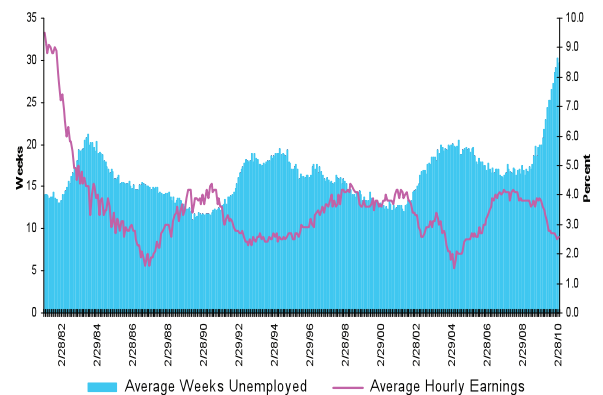
Source: Bloomberg

Manufacturing Coming Back



Source: Bloomberg

Duration of Unemployment



Source: Bloomberg

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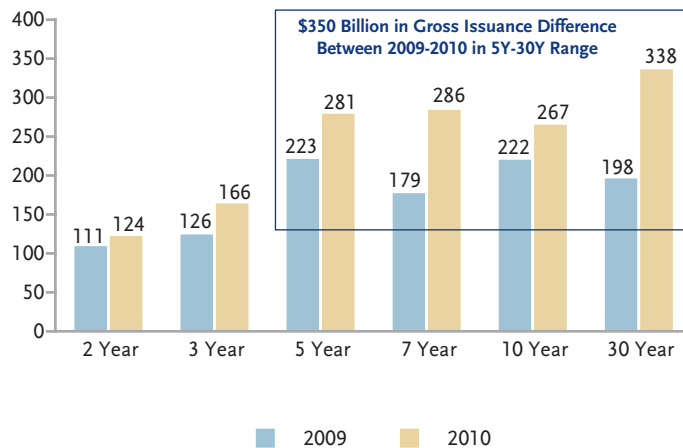
Treasury Update

Treasuries remained range bound throughout the quarter. Even with the supply induced sell off in March, levels are not all that different from year end.

	12/31/09	3/31/10	Change
1 YEAR	0.435	0.381	-0.0541
2 YEAR	1.135	1.016	-0.1196
3 YEAR	1.671	1.576	-0.0948
5 YEAR	2.679	2.557	-0.1219
7 YEAR	3.384	3.273	-0.1114
10 YEAR	3.835	3.830	-0.0054
30 YEAR	4.633	4.714	0.0808

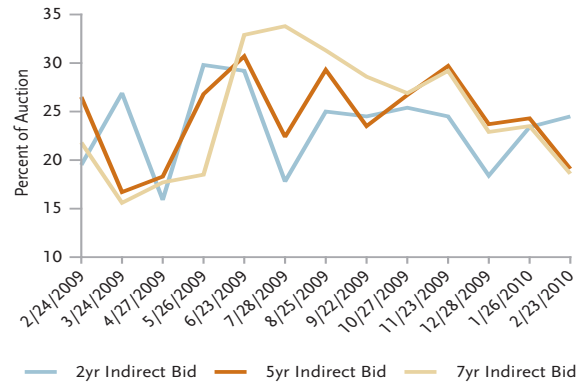
Supply continues to be a concern as gross issuance is expected to hit \$2.4 trillion in 2010 vs. \$1.9 trillion in 2009. The Treasury has made it clear it wants to term out its debt (reduce its reliance on short-term T-bills) so issuance will be focused in longer maturities and reliance on T-bills would be reduced. Net supply was \$240 billion for the quarter.

Gross Distribution in New 2010 Issuance (\$ Bn)



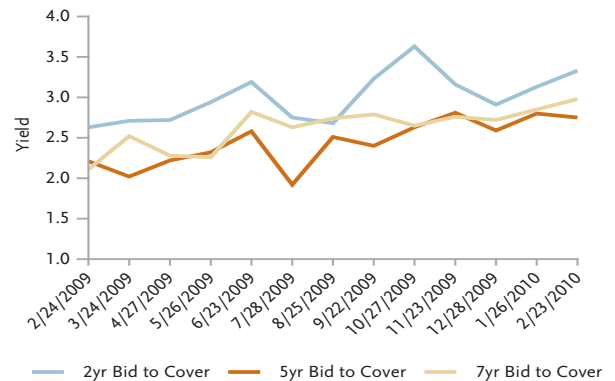
Source: Morgan Stanley Estimates

Indirect Bid



Source: Bloomberg

Bid to Cover



Source: Bloomberg

Curve

The curve did steepen out to all time highs intra-quarter, with the 2-10 Treasury curve hitting 293 bps and the 2-30 curve going to 388 bps.

	12/31	3/31	Difference
2-30	350 bps	370 bps	+20 bps
2-10	270 bps	282 bps	+12 bps
10-30	80 bps	88 bps	+8 bps
2-5	154 bps	154 bps	Flat
FF-2yr	89 bps	77 bps	-12 bps

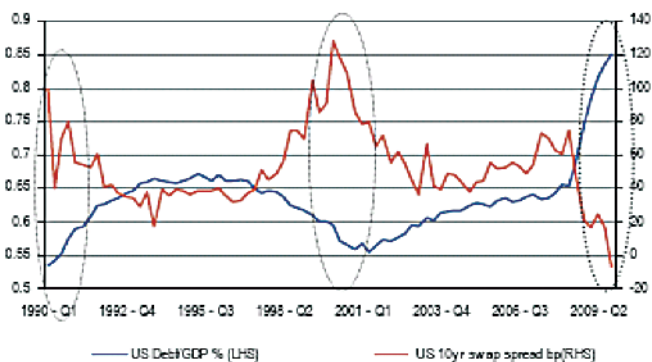
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Swaps

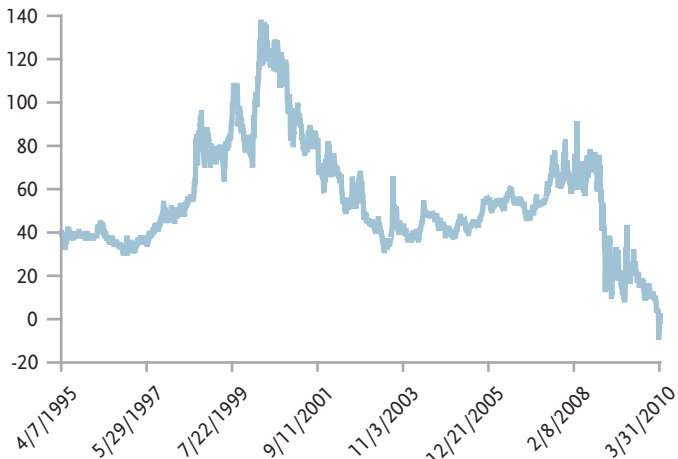
Swap spreads tightened to historic tights in the 10-year sector. Swap spreads have tightened to Treasuries for the past six months. The graph below demonstrates a correlation between 10 swap spreads and debt/GDP. Recently, as Treasury debt has increased, swap spreads have tended to tighten. In the late 90s, we had the opposite dynamic: debt burdens were dropping and Treasury debt was being paid down. Conversely, we are skeptical of the theory that swap debt has tightened because it is viewed as having less “default” risk than Treasuries.

Debt-to-GDP Matters for Swap Spreads in Large Moves



Source: Bank of America

10y Swap Spreads at Historic Tights

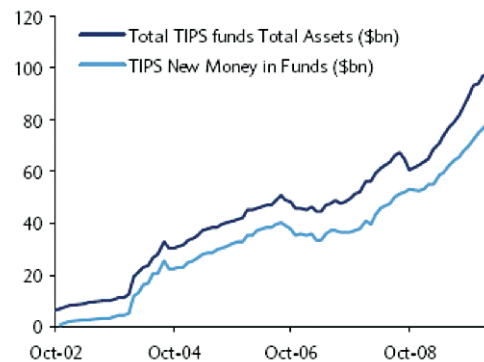


Source: Bloomberg

TIPS

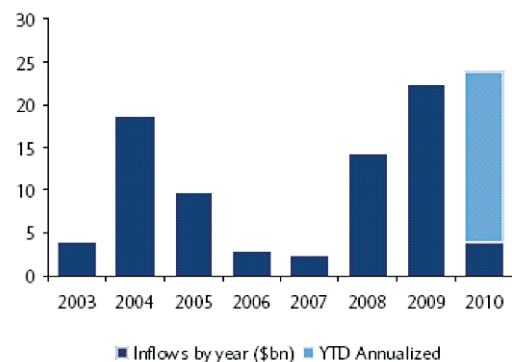
The TIPS market is entering a crossroads. Returns last year were bolstered by an unusually high real yield early in 2009 and concomitantly massive inflows to the TIPS sector. The inflows were no doubt driven by inflation fears as the Fed’s quantitative easing programs ballooned the Central Bank’s balance sheet to over \$2 trillion. This year, real yields are near historic lows and recent inflation readings have been cyclically restrained, as we had our first negative core inflation reading since 1983. Supply will also be somewhat of a question: the Treasury wants to expand its TIPS issuance and gross issuance is slated to be around \$80 billion. Net issuance is actually lower this year dropping to \$34 billion from \$38 billion last year.

New Money into TIPS Funds Climbing



Source: Bloomberg, Barclays Capital

Inflows into TIPS Funds by Year



Source: Barclays Capital

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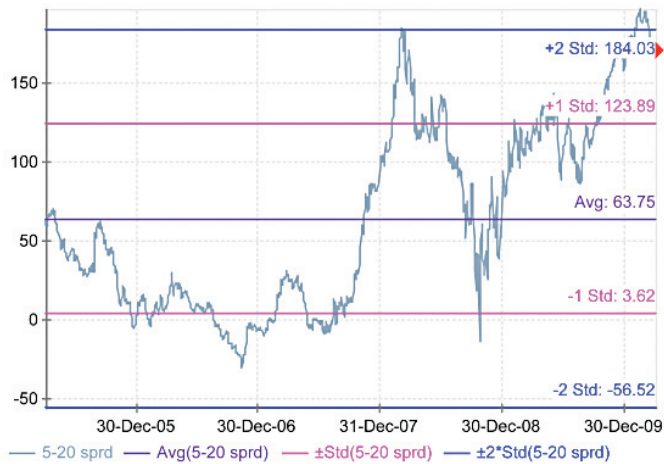
TIPS-Auctions

The Treasury decided to do away with the 20 year TIPS and bring back the 30 year TIPS. Demand was tepid at the auction though it traded well in the secondary markets. There was a new 10 year TIPS auctioned in January that was well bid with a solid cover of 2.65x.

	12/31 yield	3/31 yield	Difference
5 yr	0.20%	0.38%	+0.18%
10yr	1.42%	1.57%	+0.15%
20yr	2.00%	2.12%	+0.12%
30yr	2.14%	2.16%	+0.02% ²

The real curve (much like the nominal curve) remains very steep and sits near all time highs. We view good value in the 5-7 year TIPS maturities. Short issues are trading rather rich with negative spreads to Treasuries.

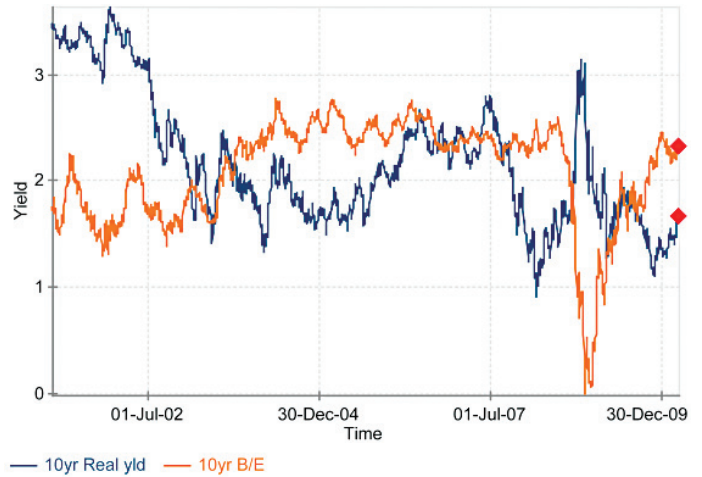
TIPS 5-20 Curve



Source: Credit Suisse Locus

2 New issue brought in February.

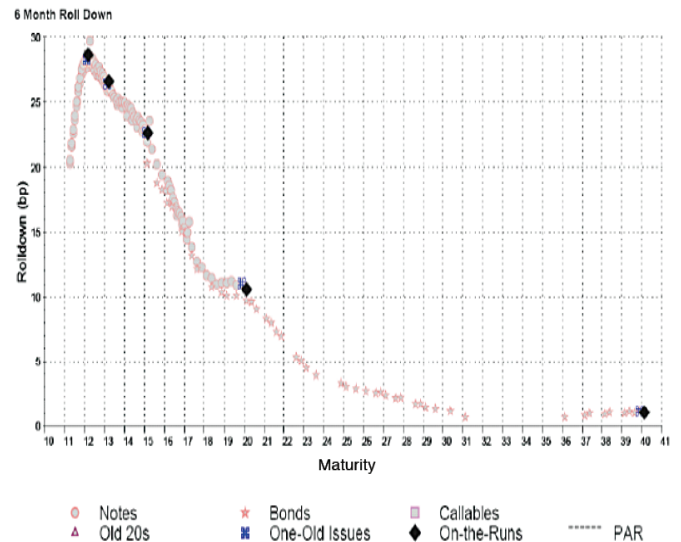
10yr Real Yield vs 10yr Breakeven



Source: Credit Suisse Locus

Roll down is still attractive in the front end of the curve, peaking with the 2 and 3-year maturities.

2yr Still Has Best Roll Down on the Curve

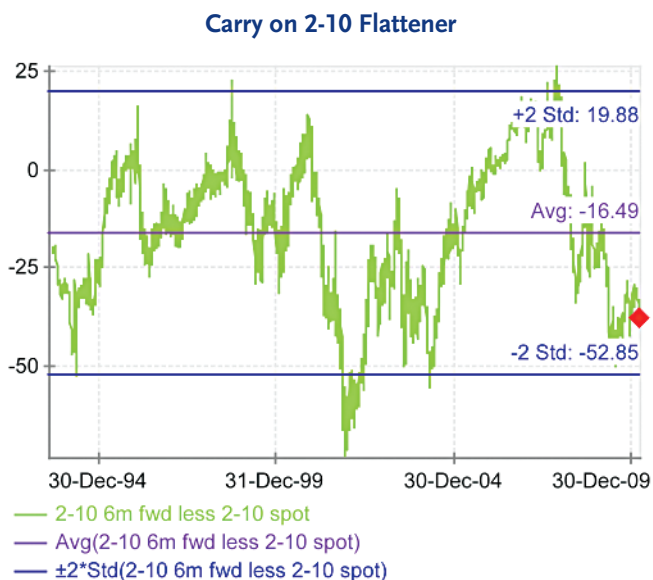


Source: Credit Suisse Locus

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The 6 month forward carry on the 2-10 flatteners at minus 52 bps implies very flat forward curve.



Source: Credit Suisse Locus

Conclusions

The Fed is likely to keep the front end of the curve firmly anchored as it is loath to raise rates, particularly given ongoing weakness in the labor markets. Conversely, market concerns surrounding inflation will promote a continuation of the steep Treasury yield curve. In general, we view Treasury rates as below their long-term equilibrium yield levels. Swap spreads remain near their historic tight to Treasuries, perhaps a result of the on-going deluge of Treasury supply. Meanwhile, real yields in the TIPS market have dropped sharply, leaving little “meat on the bones” in this sector.

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