

Eaton Vance Viewpoint October 1, 2009

Market Insight

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The third quarter of 2009 showed a continuation of the positive trends in U.S. credit markets that began in the first quarter of the year. This is a welcome development because it was the rapid deterioration in global credit markets that led us into the economic downturn, and we believe improving credit markets will lead us out. No question that much of the improvement can be attributed to historic monetary and fiscal stimulus. An indicator of improved credit health is the so-called “TED” spread, that is, the spread between 3-month LIBOR (the average rate at which large banks are willing to lend to each other) and the yield on 3-month Treasury bills. Notably, the TED spread spiked from about 1.0% to over 4.5% when Lehman Brothers defaulted last year. Today, it has fallen to below 0.5%, a level we haven’t seen since before the subprime mortgage crisis began. In addition, robust year-to-date investment-grade and high-yield bond issuance has helped many corporations refinance and extend debt maturities, alleviating pressure on balance sheets. With the exception of certain debt issued by financial companies, most of these bonds came without government guarantees.

Yet, despite these indications of improving credit markets, we find that both corporate and household debt outstanding fell in the first part of the year. Banks appeared less willing to lend to companies and individuals (and if they did so, it was at a relatively high costs), and borrowers appeared less willing to borrow. Thus, despite the contraction in credit spreads in capital markets, a full healing and return to normal credit conditions has yet to occur, which, in our view, could dampen the pace of economic recovery. In fact, over the longer term, we believe we are at the beginning of a deleveraging trend by both individuals (e.g., higher savings rates) and companies. This “private debt unwind” may also impair future growth.

And what about the impact of the Federal Reserve (the Fed) “ballooning” its balance sheet from under \$1 trillion to over \$2 trillion? Won’t this lead to inflation? In our opinion, with so much slack in the U.S. economy as measured by a historically low percentage of capacity utilization, a historically low velocity of money—the rate at which money is created or changes hands—and a weak consumer, inflation appears not to be in the cards—at least in the near term. The so-called Treasury Inflation Protected Securities (TIPS)¹ break-even point, that is, the yield differential between a 10-year Treasury bond and a 10-year

TIPS, is currently at 1.6%, below its 10-year average of 2.0%. This indicates that longer-term inflation expectations remain in line with those over the past decade.

But key questions remain: When will the Fed/Treasury take the steps necessary to reverse the course of their stimulus actions—when the U.S. economy heats up, or when prices on financial and hard assets climb to unhealthy levels? We believe it will be very difficult for them to time their exit perfectly and, with unemployment levels remaining stubbornly high, it will be politically challenging to execute the exit in a timely manner. Higher interest rates could result. In short, due to improvements in credit markets, we feel that deflation is now less of a risk. However, though we expect a relatively slow economic recovery, we feel that when a recovery does come there is a real risk that the Fed/Treasury may “fall behind the curve” due to the sheer magnitude of the liquidity support programs they have to unwind.

Implications for Fixed Income Strategies

First, we note that long-term municipal bonds, investment-grade bonds, bank loans and high-yield corporate bonds have had a great run year to date, generating equity-like returns as credit markets and spreads have improved and tightened, respectively, faster than we anticipated. Second, we observe that though the “trade” to make big capital gains in these asset classes appears to be in the late innings, we believe that the current improved prospects for economic growth, albeit slow growth, bode well for these spread asset classes going forward. Generally, credit spreads remain above their 10-year averages, indicating that investors have the opportunity to “earn” their coupon plus some possible capital appreciation. In an investment world sitting on much firmer ground than what we experienced at the beginning of the year, we believe these lower expected returns remain compelling on a risk-adjusted basis.

The average yield on high-quality, long-term municipal bonds relative to Treasury bonds with comparable maturities—the so-called “muni ratio”—is at a level just below 100%, still above its long-term average. At the shorter end of the curve, muni ratios are not as compelling; in this part of the curve, it makes sense to consider bond strategies that seek to maximize after-tax total return by investing in both municipal bonds and U.S. Treasuries/agencies. We note that all municipal bond strategies could benefit from anticipated increases in individual tax rates, while long-term munis should continue to benefit from a reduction in muni bond supply due to the ongoing issuance of taxable municipal “Build America Bonds”² to institutional investors.

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Among riskier credit sectors, given (1) improving credit markets for corporations and (2) recent gains in the dollar price of investment-grade, high-yield and bank loan indices, high yield and bank loans seem most attractive, as their current average credit spreads remain well above their historical averages. With a deceleration in the pace of rising defaults and expectations for default rates to fall next year, as well as close-to-double-digit coupons, high yield remains particularly interesting. Despite their low current yields, floating-rate bank loans offer protection from the scenario of rising short-term interest rates, whose timing is difficult to predict but which we believe will almost certainly occur (given close-to-zero short-term rates)!

Finally, and due to uncertainty as to how quickly the U.S. economy will recover or how effective the Fed and Treasury's exit will be, asset allocation strategies that seek to invest across multiple low-correlated fixed-income asset classes may result in the highest risk-adjusted returns. Asset classes in the mix could include the corporate debt asset classes discussed above, as well as seasoned agency mortgage-backed securities (MBS), asset-backed securities (ABS), commercial mortgage-backed securities (CMBS), U.S. Treasuries and an international/emerging markets foreign currency/ sovereign debt component.

Sincerely,



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¹Treasury Inflation Protected Securities are bonds issued by the U.S. Treasury that pay a semiannual interest rate tied to the Treasury auction plus an additional interest rate tied to the rate of inflation during this semiannual period.

²Build America Bonds are taxable bonds issued by state and local governments for capital projects for which they receive a new direct federal subsidy payment from the Treasury Department for a portion of their borrowing costs.

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