



Tim Anderson, CFA • Kevin Nicholson

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## Fixed Income Markets – Still Waiting for Clarity

The financial markets have been on a risk reward/aversion roller coaster ride during the first half of 2010. This unpleasant ride has been especially pronounced over the past couple of months, giving mixed signals that have left many investors feeling whipsawed. Just over a week ago, the ten-year Treasury yield fell to 2.93%, its lowest level since the financial crisis began to abate in April 2009. The drop, from 4% in early April, was precipitated by the European debt crisis, concerns about a Chinese slowdown, and resultant fears of a double-dip recession and deflation. These fears led investors to shed riskier assets and flock to the liquidity and perceived safety of US Treasuries. Over the past week, however, the yield has risen back to around 3.1% as risk aversion has eased slightly. In a *Fixed Income View* about a month ago (6/16/10) we had laid out some of the signals that we are monitoring to guide our risk allocations. Given their continued lack of clarity, we remain about neutral to fixed income risk assets against our new asset allocation models.

**Ten-Year Treasury:** The chart below shows three occasions over the past 10 years when the 10-year Treasury yield fell to 3.1% or less: (1) on 6/13/03 the yield fell to 3.11% during another brief deflation scare, (2) on 12/30/08 the yield fell to 2.05% in the aftermath of the Lehman Brothers bankruptcy, and (3) on 7/6/10 the yield fell to 2.93% during the current double-dip recession/deflation scare. In the first two instances, yields backed up fairly quickly and high yield spreads began to tighten either a few months before (March 2003) or almost coincidentally with (December 2008) rates bottoming. Over the past several trading days, the 10-year yield has risen back to the 2003 lows as the global financial landscape has shown some small signs of improvement. However, we would like to see the yield rise further, at least firmly back into its previous trading range between 3.20% and 4%.



Source: Bloomberg; Past performance is no guarantee of future results.

**High-yield credit default swaps:** We had previously laid out a 625 to 700 decision box for high yield credit default swaps (CDS), with a significant break below 625 as a signal for adding risk and 700 as a signal to lower risk. As we went to press on 6/16/10, high yield CDS had just broken through the lower end of this range and subsequently hit 575 on 6/18/10 before moving back above 625 in late June. We did not view this move as decisive; given its brief duration and the lack of confirmation from our other signals, we did not change our high yield allocations. We are now viewing 574 as the bottom end of our decision box for high yield, as CDS has been

turned away twice at this level. Once again as we go to press, CDS has just broken through the lower end of our range closing at 566 on 7/13/10. We do not view this move as decisive given the short time period and magnitude and the lack of confirmation from our other signals. *High-yield securities are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities.*

### High-Yield Credit Default Swap Spread



Source: Bloomberg; Past performance is no guarantee of future results.

**VIX:** The Chicago Board Options Exchange Volatility Index (VIX) measures the implied volatility of S&P 500 index options and is often referred to as the “Fear Index.” Last month, we wrote that we would view a decisive break below its 100- and 200-day moving averages (then around 23) as a favorable signal. The VIX has approached its 100-day moving average (which has since moved up to 24) twice in the last month, but has been turned away both times.



Source: Bloomberg; Past performance is no guarantee of future results.

Tim Anderson, Chief Fixed Income Officer • 804-549-4806 • [tanderson@riverfrontig.com](mailto:tanderson@riverfrontig.com) •  
[www.riverfrontig.com](http://www.riverfrontig.com)  
 RiverFront Investment Group, 9011 Arboretum Parkway, Suite 110, Richmond, VA 23236

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