



# Market Flash

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## FIXED-INCOME MARKET COMMENTARY

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### Fixed-Income in Review

The first quarter of 2007 was dominated by a marked increase in uncertainty about the U.S. growth outlook. Part of the problem was the impact of volatile weather conditions, which had distorted a number of economic data releases since the fall of last year. A second source of uncertainty was the growing number of headlines covering the problem of accelerating delinquencies in the U.S. sub-prime mortgage market, which have started to cause a number of high-profile bankruptcies among lenders heavily exposed to the market segment. In February, such concerns about the U.S. economy led to a sudden increase in risk aversion among investors, which triggered a sharp sell-off in global equity markets.

### Fundamentals Drive the Market

Ten-year U.S. Treasury bond yields started the year in an upward trend that eventually peaked at 4.90 percent in late January, when the first estimate of U.S. gross domestic product (GDP) for the fourth quarter of last year reported an increase in growth to 3.5 percent. That would have meant the period of below-trend U.S. growth had come to a much earlier-than-expected end despite the ongoing problems in the housing sector. However, market sentiment changed quickly, and starting in February, the tone of U.S. economic data releases have again turned decidedly more bearish. The strong GDP growth for the fourth quarter of last year was revised from 3.5 percent to a much less impressive 2.5 percent, which fuelled a bond market rally that eventually pushed yields back down to 4.49 percent.

In the past few weeks, a surprise increase in inflation and the lack of evidence of a shift in U.S. monetary policy lifted bond yields higher again, though this time, longer-term U.S. Treasury bond yields rose more than those with shorter maturities. The yield curve 'inversion' between the 10- and two-year bond yields has been reversed and, for the first time in nine months, the curve has a positive slope. Even though the Federal Funds Futures market is pricing in fewer interest-rate cuts for the second half of the year, bond markets are still very much expecting the Federal Reserve to lower interest rates later this year with both the two- and 10-year U.S. Treasury yields more than 50 basis points below the current Federal Funds rate.

### Inside the Mind of the Federal Reserve

However, if there has been one constant throughout the macro volatility during the first quarter, it was the Federal Reserve. Repeatedly, in speeches, the minutes from the two recent Federal Open Market Committee (FOMC) meetings, and Federal Reserve Chairman Ben Bernanke's Congressional testimony in February, the Federal Reserve reaffirmed its confidence in the economy. Officials acknowledged the problems in the housing sector, but so far the U.S. central bankers are not concerned about their forecast of continued moderate growth in the coming quarters. In March, the FOMC changed its policy statement, removing an explicit reference to an interest-rate hike as its next potential move. However, the Federal Reserve retained a firm inflation focus at their last meeting, and the recent increase in inflation is still running well above the bank's one- to two- percent comfort zone. The lacking validation of interest-rate cut expectations is another reason for the recent upward trend in bond yields. We are still looking for underlying inflation trends to moderate again, but the rise in oil and gasoline prices in recent weeks and the weaker U.S. dollar have clearly increased the risk that prices might not moderate as fast as the Federal Reserve would like to see.

### Where Are We Going From Here?

Looking ahead, investors are still waiting for a stronger consensus to emerge on where the U.S. economy is heading. Key Wall Street economists remain split on whether we are headed for a more severe slowdown in the second half of this year or whether we are in a mid-cycle slowdown that will end over the summer. To that end, data flow in the first quarter has been inconclusive. The absence of measurable evidence that more bearish predictions are coming through supports our forecast that the U.S. economy is likely to maintain a two- to 2.5-percent growth trend in the first half of this year. If we are correct in our prediction that growth headwinds from housing will ease over the summer and GDP growth re-accelerates back above three percent, then bond markets have more adjusting to do and bond yields are likely to trend higher over the course of 2007. ■

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