

FIXED INCOME REPORT

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First Trust
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This is the inaugural edition of the *FIXED INCOME REPORT* from the First Trust Fixed Income Advisory Group. This on-going research and strategy effort will seek to provide analysis of the current backdrop, recent developments and important themes to watch, as well as our outlook for the fixed income markets.

Have Long-Term Treasury Rates Overshot Prudent Levels?

Now more than ever, analysis of fixed income markets comes down to two essential questions:

- » Have longer-term risk free rates (represented by the U.S. Government Treasury bond market) overshot “prudent” levels as a result of a flight to quality/liquidity?
- » Do credit spreads (on corporate debt, mortgage product, and municipal bonds) - despite trading at close to historically wide levels versus treasuries - adequately compensate investors for what are arguably close to historic levels of risk?

We will consider the first question in this report and will address the latter in an upcoming report.

Yields are Near Historic Lows

Having averaged a yield of 4.55% for the past decade, the 10-year treasury note hit a historic low of 2.04% on December 18th of last year. Since then, the U.S. Government bond market has experienced its worst start to a new year since 1987 – with the 10-year note having traded above a 3% yield for the first time since November before rallying to around 2.87% currently. So is it a buy?

10-Year U.S. Treasury Yield



Technical Reasons for the Treasury Selloff

One cause of the backup in treasury yields has been technical. The extreme fear of counterparty risk that paralyzed the money markets and brought interbank lending to a grinding halt has dissipated somewhat. Treasury bill rates remain low (with the 3-month bill currently trading at .198% as of March 6, 2009), but this is still a far cry from the negative yields seen in December that resulted from a willingness on the part of investors to - in effect - pay to own a short-term treasury in exchange for the knowledge that the issuer wasn't going to default (like Lehman Brothers) or become illiquid (like the Reserve Primary Institutional Money Fund).

Fundamental Reasons for the Treasury Selloff

There are fundamental reasons, however, for the selloff as well.

1. Massive Amounts of New Government Borrowing – But Who's Buying?

With passage of the recent stimulus package, focus has increasingly turned to the implications of financing such a massive increase in government borrowing. The quarterly refunding announcement (in which the U.S. Treasury informs the market of the size and makeup of its borrowing plans for the quarter), for example, was for an amount roughly 1/3 more than the consensus estimate. Estimates for the current fiscal year's borrowing needs have, in fact, increased to a record-setting \$2.5 trillion, from last year's \$892 billion, according to Goldman Sachs Group, Inc. As foreign buyers of treasuries announce domestic stimulus programs for their own economies, legitimate concerns as to who will step up to buy the additional issuance continue to mount.

Have Long-Term Treasury Rates Overshot Prudent Levels? *(continued)*

2. Allusions, but No Commitment to Stabilize Long-Term Rates

A further reason for higher treasury yields has been that despite several statements by the Federal Reserve that it is considering purchasing longer-dated treasuries in order to keep rates low, there has as yet been no confirmation as to details on size, timing, etc., or even a statement that the Fed has committed to anything beyond consideration of purchasing treasuries as an option. Nonetheless, this could change at any time.

3. Potential for Deflation or Negative GDP Growth

Moreover, in the minds of treasury market bulls, the scenario under which the Fed could be prompted to actively seek to drive down longer-dated yields would in and of itself likely result in retesting (or even rallying through) December's low yields. The Fed could, in other words, add fuel. This is because while there is near consensus that at some point government attempts to reflate the economy through loose monetary policy and massive fiscal stimulus will take hold, and the Fed will have to reverse direction, there are a variety of outcomes in the meantime which could involve a prolonged period of deflation and/or negative GDP growth. Under such dire circumstances,

it would be reasonable to assume that treasuries could rally from current levels and remain there for an extended period of time. Japan's "lost decade" in the 1990s comes immediately to mind as an example of the possible downside to our economy.

Government Bonds: Not Necessarily a Long-Term Safe Haven

In the end, the question as to value in the U.S. treasury market does not have an easy answer. From the perspective of whether or not to be long treasuries for a shorter-term trade, there are good arguments either way. What is clear, however, is that from a longer-term perspective, U.S. government bonds are not a safe haven. If the economy and the markets turn, it could be dramatic. And then in the words of one market commentator, investors in treasuries may have found their investment has gone from risk-free return, to return-free risk.

-Eric Maisel, CFA

The information in this report is based upon sources and data believed to be accurate and reliable. This information does not constitute a solicitation or an offer to buy or sell any security.

About the First Trust Fixed Income Advisory Group

The FIXED INCOME REPORT is produced as a cooperative effort between fixed income analysts from First Trust Institutional Capital Markets and BondWave.

First Trust Portfolios L.P. ("First Trust") is a regional broker dealer, headquartered in Wheaton, Illinois, a western suburb of Chicago. The firm was founded in 1991, and with its affiliates has grown to over 400 employees who assist customers with their financing and investing needs. First Trust is a recognized leader in providing innovative financial products and services to the marketplace. We are the single largest wholesale originator of unit investment trusts in the nation. Our Institutional Capital Markets and Public Finance groups offer a wide range of capital planning, underwriting, trading and a number of other value-added fixed income services.

BondWave LLC ("BondWave") is a subsidiary of First Trust Portfolios L.P. and offers a fixed income investment methodology called Program Portfolios™ that enables financial consultants to create and manage custom individual bond portfolios for each client using a model-based investment strategy. Program Portfolios allow consultants to maintain control of assets and direct the investment process, which includes strategy selection, portfolio monitoring services, customized electronic messaging and reporting. Program Portfolios enable the investment professional to offer a coordinated, white-labeled investment solution to clients who seek a flexible and cost-competitive approach to fixed income investing.

 **First Trust**
Institutional Capital Markets
www.FTCapitalMarkets.com
800.872.7276

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www.BondWave.com
877.795.6288