



# Fixed Income Asset Allocation Notes

January 2012

## Summary Portfolio Allocation Decisions

*Robert Vanden Assem, Managing Director, Head of Investment Grade Fixed Income*

We are leaving our portfolio allocations unchanged. The continued uncertainty surrounding investor reaction to European government policies and its potential impact on global growth makes us wary of taking on unwarranted risk heading into the first quarter of 2012.

## Economic Overview

*Markus Schomer, CFA, Chief Economist*

### Scenario Analysis

#### Base Case (75% Confidence Of Occurrence)

- Moderate Growth: GDP remains in a range between 2.5% and 4.5%
- US maintains a moderate growth trend in 2012, with no double dip recession
- Eurozone weakens further, but will avoid extended recession
- Asian growth continues to slow on policy tightening and weaker exports; soft landing in China
- Global inflation trend has peaked and is starting to slow
- More central banks shift to a more stimulative monetary policy

#### Bull Case (10% Confidence Of Occurrence)

- Strong Growth: Global recovery picks up to a more than 4.5% pace, driven by resumption of recovery in the developed world and stronger domestic demand in emerging markets (EM)
- Faster rising global inflation greater than 4.5%
- More rapid improvement in developed world unemployment
- Easing cycle halted, developed world starts tightening cycle; exchange rate mean reversion (stronger dollar)

#### Bear Case (15% Confidence Of Occurrence)

- Weak Growth/Recession: Global GDP growth slows to below 2.5%, driven by austerity recessions in US, deteriorating Euro Debt Crisis, hard landing in China
- Inflation slows to under 3%; deflation risk in parts of the world
- Unemployment likely to trend higher, testing recession highs
- More central banks adopt quantitative easing (QE); strong chance of more fiscal stimulus

## Considerations

- Can the eurozone avoid a more prolonged recession?
- Will central banks' easing accelerate alongside a broadening inflation slowdown?
- Will the US outlook be impacted by the 2012 presidential elections?
- Will Chinese policy easing come to the rescue (again)?

## US High Grade

*Dana Burns, Managing Director, Senior Portfolio Manager, Investment Grade Fixed Income*

### Fundamentals

Corporate balance sheets remain healthy in the US, but the trajectory of the US economy remains underwhelming, and recent consumer spending points to a weak start to 2012.

### Valuations

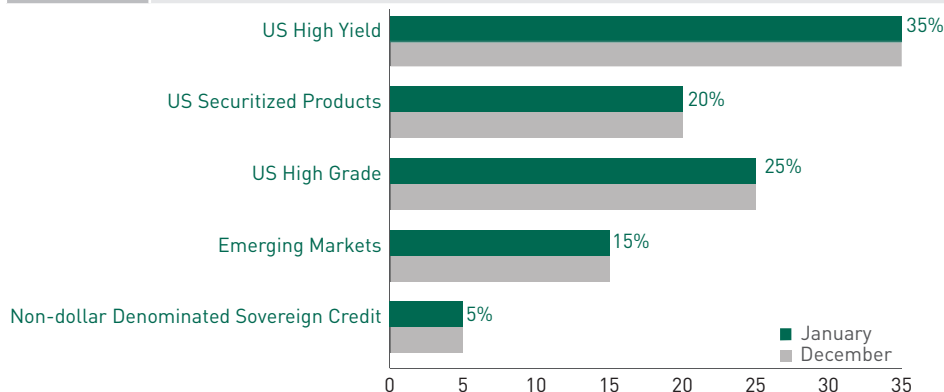
Spreads remain attractive following a small rally in December. The market is still pricing in a 75% chance of recession, an outcome we do not foresee right now. Financials remain substantially wide compared to Industrials, although the gap has narrowed in recent weeks due to stronger bank performance. As we head into the earnings period for banks, we may see the relationship widen again.

### Technicals

Broker dealer inventories remain extremely low, and most firms are still not looking to take risks in early 2012. Primary issuance has been robust thus far in January, and if supply continues at this pace it could put a damper on the market. Concern over Europe remains key if we are to have meaningful positive momentum in credit markets.

FIGURE 1

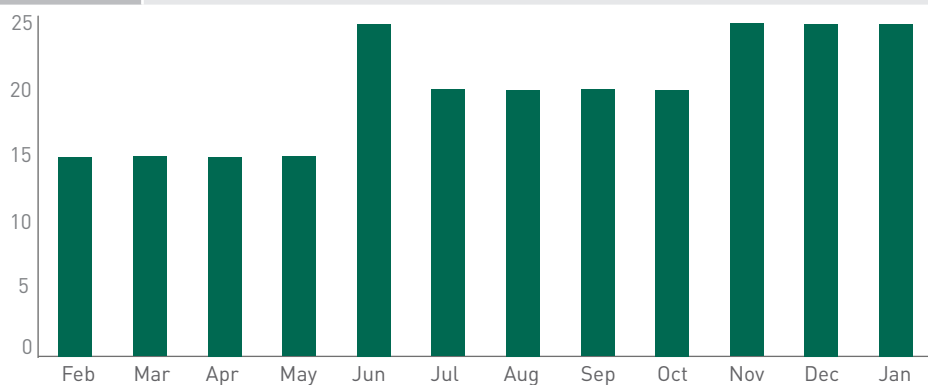
Target Allocation  
As of 20 January 2011



This is a range and there can be no assurance that the target or range will be achieved.

FIGURE 2

### Target Allocation: US Investment Grade February 2011 - January 2012



## US High Grade Bonds Allocation Decision

During the month of December, investment grade credit spreads tightened modestly in a relatively thin trading environment. The option adjusted spread (OAS) of the Barclays Credit index closed 8bps tighter at 217bps, led by strong performance from the Non-Bank Financial and Refining sectors. Sentiment surrounding risk assets improved modestly due to the European Central Bank's (ECB) establishment of the Long-Term Repo Operation (LTRO), which will provide unlimited three-year liquidity to European banks. While this certainly does not solve the sovereign issues facing the region, it does alleviate bank liquidity concerns over the near term. In light of the current uncertain macro environment, **we are holding our weighting in investment grade at 25%.**

## US Securitized Products

*John Dunlevy, Managing Director,  
Head of Securitized Products*

### Fundamentals

The same story continues for mortgage-backed securities (MBS) – rates are low and credit is still constrained; the Home Affordable Refinance Program (HARP) will try to spark refinancing, but the market expects little. MBS automatically pick up value with the increases to the guarantee fee (g-fee) that went into effect at the start of 2012, which decrease prepay risks. This is counterproductive for Obama's goals on housing.

### Valuations

MBS spreads have tightened 20 bps in a month. The OAS is now back to last year's low levels. It is still plausible to get back to 2010 levels, but technicals are more important now. Commercial mortgage-backed securities (CMBS) are tighter, but not nearly as tight as 2011 levels.

## Technicals

A myriad of events, both political and fundamental, have driven MBS spreads tighter. Agency MBS is an asset class that surely won't be scaled back in the US like other asset classes due to pending regulations.

## US Securitized Products Allocation Decision

Securitized products have performed well since late November. Agency MBS spreads ripped tighter because of the g-fee increase, slower speeds, and Dodd-Frank liquidity ratio guidance. CMBS has been tighter, as the sector has been lagging the recovery of other sectors; it was due. We have reached a good mix of MBS, CMBS and asset-backed securities (ABS) now, but the overall tone is much more positive. **We will hold our 20% allocation.**

## Emerging Markets Bonds

*Steven Cook, Managing Director,  
Senior Corporate Portfolio Manager,  
Emerging Markets Fixed Income*

*Anders Faergemann, Managing Director,  
Senior Portfolio Manager,  
Emerging Markets Fixed Income*

### Fundamentals

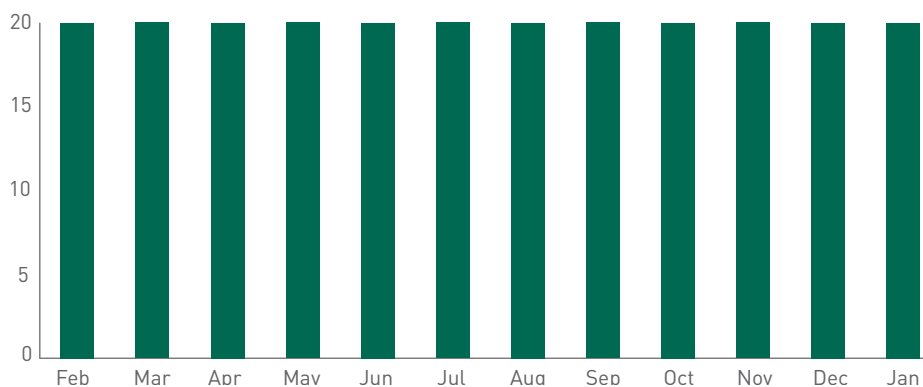
Recent US economic data appears to verify our suggestion that the US economy was unlikely to fall into a double dip recession. China has room to ease monetary policy further, while higher than expected inflation may prevent most EM central banks from easing. Generally EM growth is holding up quite well, supported by relatively strong consumer demand. Commodity prices have been held in a range in recent months and may be due for a bounce, supporting the Latin American region over others. European growth is likely to remain weak, adding woes to growth in Central and Eastern Europe, the Middle East, and Africa (CEEMEA).

### Valuations

JP Morgan EMBI Global Diversified spreads have been range bound since the heavy volatility in September and October, awaiting new impetus from the battle

FIGURE 3

### Target Allocation: Securitized Products February 2011 - January 2012



between (US) economics and (European) politics. Spreads are attractive on a multi-year basis, but timing may be an issue with the financial markets so focused on the European Debt Crisis.

## Technicals

Inflows have stalled a bit in recent weeks, but investors are sitting on cash as the levels of redemptions feared in September never came to fruition. There has been interest in US dollar denominated products, while local currency debt has seen some outflows.

## Emerging Markets Allocation Decision

The US economic growth outlook has improved, but the apparent lack of commitment by European politicians to push ahead faster with the fiscal union project and uncertainties over large EU debt maturities in February and March make emerging markets a sideshow. Indicators are all positive, and a credible resolution to the European Debt Crisis would be a great buying opportunity. We will take a cautious approach leading up to 20 March (the date of a potential Greek default) but will be ready to use weakness to close our underweight. **We will hold our allocation to EM at 15%.**

## Non-US Dollar Denominated High Grade Bonds

*Anthony King, Managing Director, Non-US Dollar High Grade Fixed Income*

### Fundamentals

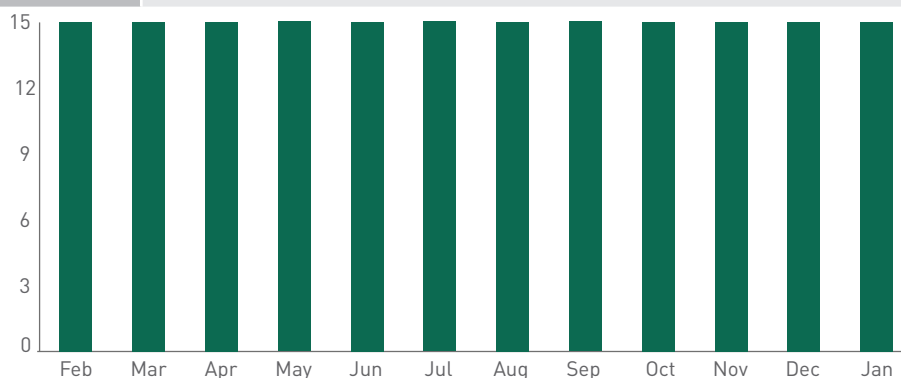
The relative growth picture is broadly favoring the US. The European outlook is now at consensus, and the European Central Bank is responding with balance sheet expansion, which is not a significant development for the euro. Japan's outlook carries greater uncertainty without greatly troubling the yen.

### Valuations

Valuations are favoring the dollar, as the non-US domestic growth/inflation mix into 2012 allows more countries to ease policy rates. Lower policy rate expectations

FIGURE 4

Target Allocation: Emerging Markets  
February 2011 - January 2012



are not adversely impacting pro-growth currencies. There is weak support for investing to purchasing power parity (PPP) themes. Interest rate differentials will be a key driver for 2012.

### Technicals

Positioning risk remains long dollar and speculative pro-dollar positions have increased. The trade-weighted dollar has been unable to break 2011 highs, reflecting a pro-risk FX approach. Individual style strategies have not provided consistent results, reflecting low risk positioning.

## Non-US Dollar Denominated High Grade Allocation Decision

We are currently balanced, reflecting a pro-commodity stance and current account surplus theme. We are underweight "safe haven" currencies, and have reduced our euro allocation further, maintaining zero allocation to eurozone peripheral markets. Intra-month, we will likely continue to marginally decrease our euro allocation in favor of the Japanese yen. Our

duration positioning is more cautious in those markets discounting significant policy easing, such as Australia and Sweden. We are comfortable with our allocation to non-dollar investment grade and **will leave it unchanged at 5%.**

## US High Yield

*John Yovanovic, Managing Director, High Yield Bonds*

### Fundamentals

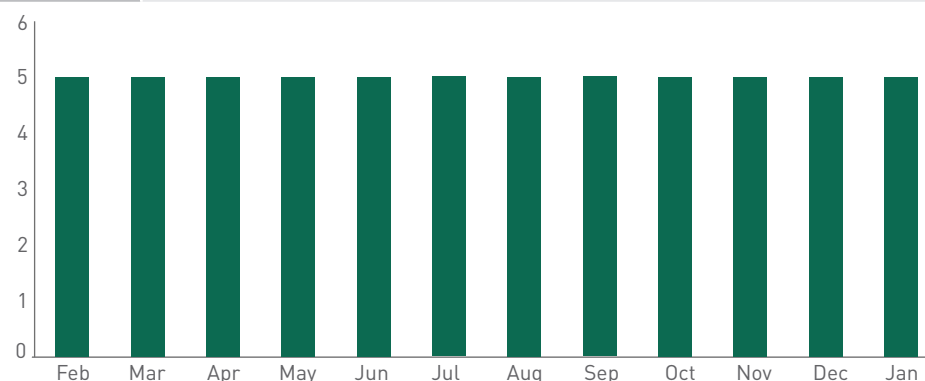
There has been no change since last month; US high yield credit is still very solid, with the exception of the CCC-rated space. We expect that the coming months will see continued gradual improvement, but the growth forecast does not appear strong enough for leveraged credits to grow into their capital structures.

### Valuations

Spreads moved from 786 bps in November to 753 bps at year-end 2011, and are now at 709 bps. Spread models continue to

FIGURE 5

Target Allocation: Non-Dollar Denominated  
February 2011 - January 2012



point to the 650 bps area as the fair value spread. The current spread implies a 6% default rate, versus our 2% to 3% 2012 default forecast. Best value appears to be in BB/B-rated credit at 669 bps.

## Technicals

Dealer market making continues to be notably weak despite strong high yield inflows and the CBOE Volatility Index (VIX) being at approximately 20. 2011 ended with over US \$15 billion of net inflows, and 2012 has seen strong inflows year-to-date. Primary issuance has picked up, yet remains light relative to historical trends. It is positive that US dollar assets have, so far, appeared to decouple from euro headline volatility; this will be an enormous positive if it holds.

## High Yield Bonds Allocation Decision

2011 ended with a strong rally, which has continued in January, but US high yield is still range bound at 650bps to 750bps due to eurozone concerns. In light of the uncertain macro environment, **we will maintain our high yield allocation at 35%.**

## Leveraged Loans

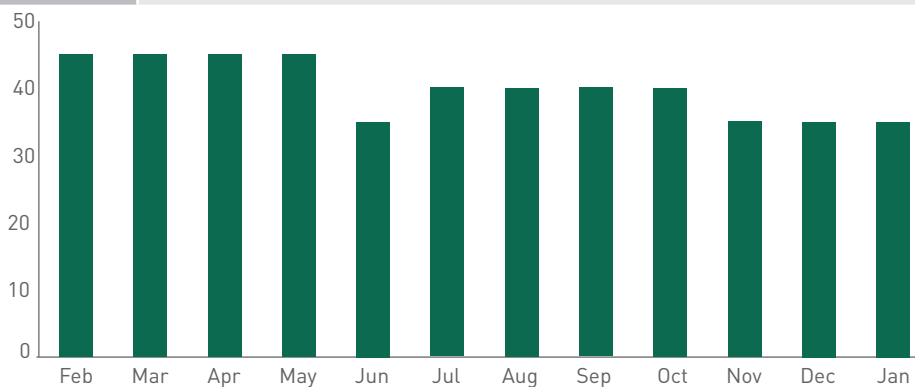
*Julie Bothamley, Managing Director,  
Leveraged Loans*

## Fundamentals

Earnings remain stable to positive. Issuers remain defensive, with good liquidity and modest (if any) growth capital deployment. The outlook for defaults has ticked up slightly, due in part to upcoming maturities and difficult refinancing conditions.

FIGURE 6

Target Allocation: US High Yield  
February 2011 - January 2012



## Valuations

The average four-year discounted spread of the leveraged loan index widened about 35bps to LIBOR+657bps during the month, mostly due to CCC and second lien widening. Loans rallied in December on somewhat positive European developments. Yield, relative to fundamentals, remains attractive, but loan prices still hang on fragile technical conditions.

## Technicals

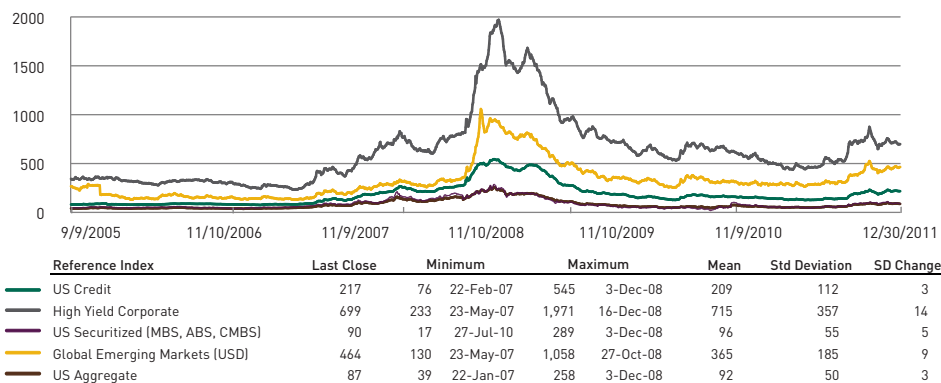
Demand for loans remains weak, given lingering uncertainty over the European Debt Crisis and related concerns over the stability of the financial system. Given slow and sometimes bumpy progress toward resolution, we expect continuing technical volatility.

## Leveraged Loans Summary

Valuation is attractive relative to fundamentals. Within high yield, loans offer relatively good downside protection in bearish markets, given their high recovery rate in the event of default. ■

FIGURE 7

Option Adjusted Spread (OAS)  
As of 31 December 2011



Source: Barclays Capital

Past performance is not indicative of future results.

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