

Morningstar Bond Market Commentary

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Rising Tide Lifts All Boats

Equities, bonds, and commodities continued to register strong gains for the second month in a row. The Morningstar Core Bond Index—a broad measure of the US fixed-income market—posted a gain of 0.42% in May. While most asset classes have been rising, the big exception has been government debt. There has been a record issuance of sovereign debt worldwide, leading to rising interest rates. The Morningstar Treasury Bond Index fell 1.03% over the month. Positive economic indicators have provided enough catalyst to lift the corporate bond markets. The Morningstar US Corporate Bond Index rose 3.49% in May.

Rating Agency Warning Shots

Rising government yields across the globe accelerated after Standard & Poor's lowered its outlook on the UK's triple A credit rating on May 21 to negative from stable, heightening concerns it may do the same to other triple A borrowers, including the United States. The UK Treasury Index fell 1.25% for the month and is down over 3% for the year. In an effort to stabilize interest rates, the Bank of England and the European Central Bank will be increasing open-market bond purchases. The European Central Bank lowered its benchmark rate to 1%.

In a move the agency described as largely technical, Moody's lowered the Japanese government's triple A foreign currency credit rating two notches to Aa2. The description as technical results from the fact that Japan has almost no foreign currency debt exposure. Japan is one of the most indebted countries in the world, with the value of its debt more than 170% of gross domestic product. The move was also intended to provide separation from triple A borrowers such as the US, France, and Germany.

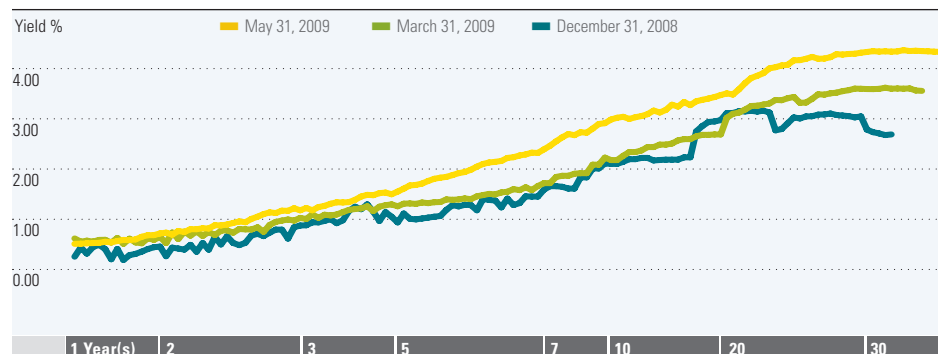
Longer-maturity Treasury yields continue to rise while shorter maturities, anchored by the Federal Reserve's easy monetary policy, were steady. The yield on the 30-year Treasury benchmark rose close to a six-month high of 4.26%. The resulting steepening has put the spread between the 2-year

and 10-year Treasury yield spreads near record levels. The Long-Term US Government Bond Index (7 or more years to maturity) fell 2.30% in May, while the Short-Term Index (1-4 years to maturity) rose 0.22%. The higher rates precipitated from the coming record supply and the quantitative easing that is pumping money into the economy. Both contribute to escalation of inflation expectations.

Corporate Rally Continues

Corporate debt as an asset class continues to provide very strong absolute and relative returns. The decoupling with sovereign debt continues apace. The correlation between Treasury and US corporate 12-month trailing total returns has fallen for the fifth consecutive month and currently stands at 0.33. The only measure lower in the last 10 years was 0.23 in September 2008.

Treasury Yield Curve



The Morningstar US Corporate Bond Index rose 3.49% in May. The yield premium on the index fell 88 basis points to 344 in May. A similar decoupling persists in both the euro zone and the United Kingdom, where in both cases the government sectors had negative returns while corporate credits had positive returns.

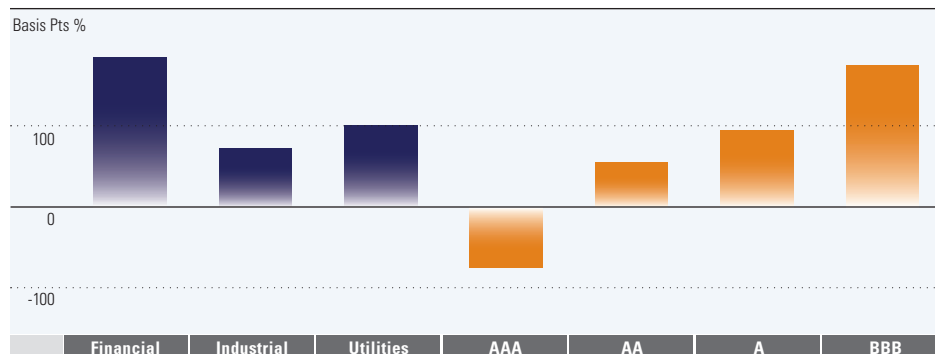
In the US the financial sector was the strongest performer for the second consecutive month. A 5.75% return in May was the second-highest month on record of the past 10 years. Using yield premium as the market's measure of risk, participants still see the financial sector as the riskiest, followed by industrials and utilities.

Bondholders looking for the silver lining in the General Motors bankruptcy should consider the impact on the cost of protecting corporate bonds from default. Indexes that measure the cost of protecting the riskiest of debt have fallen dramatically on the speculation the bankruptcy will be pain-free, and some consider it a signal that the worst of the credit crisis is over.

Emerging Markets Continue Comeback

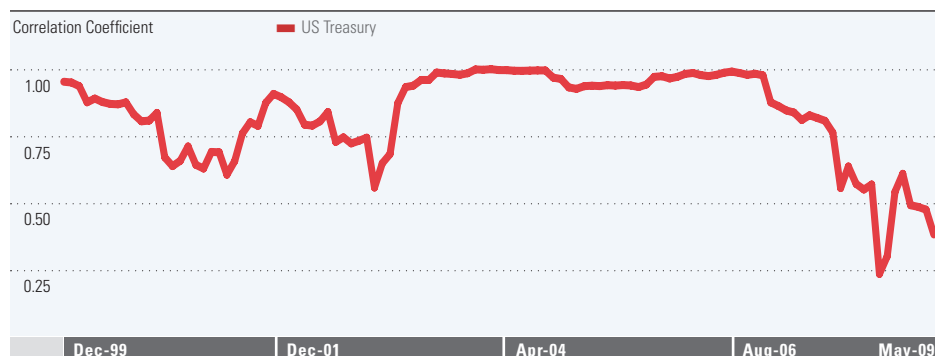
With few exceptions, emerging markets are enjoying a recovery in all sectors on scale with the recent demise. Emerging countries' economic health is often contingent on the strength of their exports and has benefited from the rebound in commodity prices. The Morningstar Emerging Market Composite Index—a measure of sovereigns and high-yield corporate bonds—rose 4.81% in May and is up more than 14% on the year. The high-yield corporate component rose 11.05% and the sovereign component rose 3.43% in May. ■■

Credit Spread Change by Sector and Quality—1 Year



Credit spread is the yield difference between the US Treasury Index and the underlying sector and rating indexes.

Correlation of Corporate and US Treasury Monthly Total Returns—1 Year Trailing



Correlation coefficient between Morningstar's US Corporate Bond Index and Morningstar's US Treasury Index 1-year trailing monthly total returns.

Morningstar Bond Indexes

		Total Ret Mo. End 1 month	Total Ret Mo. End 3 month	Total Ret Mo. End 6 month	Total Ret Mo. End YTD	Total Ret Annul 1-Year	Total Ret Annul 3-Year	Total Ret Annul 5-Year
Broad Market	Core Bond	0.42	1.79	4.01	0.71	6.96	7.03	5.47
Sector	US Govt Bond	-0.86	-0.47	-0.10	-3.59	7.73	7.69	5.65
	Corporate Bond	3.49	6.18	12.03	5.28	1.50	4.32	3.85
	Govt Guaranteed	0.54	1.72	—	2.09	—	—	—
	Mortgage Bond	0.14	1.86	4.38	2.67	9.45	7.95	6.18
Maturity	Short-Term Core Bond	0.78	1.88	3.45	1.87	5.03	5.89	4.27
	Interm. Core Bond	0.14	1.76	4.17	2.12	8.62	7.71	5.32
	Long-Term Core Bond	0.66	1.63	4.45	-3.85	5.31	6.71	5.66
Inflation Prot. Secs.	TIPS	1.87	5.69	10.12	5.01	-0.08	5.74	4.92
Global Bond	Global Govt Bond USD	3.22	6.39	5.23	-1.65	4.02	7.17	5.92
	Global Govt ex-US USD	4.62	7.56	7.00	-1.02	2.98	7.07	6.10
	Eurozone IL	-1.47	0.44	1.30	0.31	9.16	4.49	4.43
	Swiss IL	-1.68	-0.66	1.05	0.15	9.48	3.75	3.57
	UK IL	-1.28	0.89	2.63	-2.39	12.07	5.73	6.15
	Australasian USD	7.33	21.00	19.88	8.85	-6.56	8.43	8.32
	Canadian IL	-1.59	-0.69	2.51	-1.87	7.01	6.59	6.12
	Japanese IL	4.08	3.44	4.94	3.06	7.97	3.73	2.35
Emerging Market	Composite USD	4.81	14.76	23.40	14.83	-3.17	4.51	7.83
	Sovereign USD	3.43	11.88	19.80	11.50	-0.72	5.93	8.78
	Corporate USD	11.05	28.39	40.29	30.55	-9.11	1.43	5.44

USD—unhedged returns in USD IL—returns in local currency