Fixed Income
Fourth Quarter, 2008

The bad news continued in the last quarter of 2008. Following the United States government seizure of Fannie Mae and Freddie Mac and bail out of American Insurance Group, the U.S. Congress passed the $700 billion Troubled Assets Relief Program, or TARP, in October, in order to rehabilitate the U.S. banking industry and provided a $14 billion life line to the "Big 3" U.S. automakers in December. By year end, the National Bureau of Economic Research had confirmed what many had suspected; the United States, the world's largest economy, had been in a recession for a year. December also saw 524,000 jobs lost in the United States, the highest level in 34 years, with the unemployment rate reaching 7.2%, its highest level in 15 years.

As predicted last quarter, the U.S. Federal Reserve (Fed) was forced to cut interest rates three times during the quarter, from 2.00% to a new record of 0.25%. Responding to slightly better but quickly deteriorating economic news in Canada, the Bank of Canada reduced interests from 3.00% to 1.50%. Despite this and other aggressive intervention by central bankers, liquidity did not improve and credit spreads, the difference between the interest rate on government bonds and corporate bonds, finished the year at record highs.

The leading indicators of neither the ECRI nor the Conference Board have bottomed, which suggests the recession will continue for at least two or three quarters. Other indicators, however, suggest that it could continue longer. Historically, the unemployment rate, the employment/population ratio, and initial claims are excellent early warning signals for the peak of the cycle. They also offer a pretty good indicator of when a recession is ending as well. On average claims peak a couple of months before a recession troughs, and then decline quickly. Even in the jobless aftermath of the 2001 recession, claims peaked a month before the bottom, and then fell by 25% over the next four months. Needless to say, recent experience looks nothing like that now; not only are claims not turning down, they are accelerating and breaking out to new highs. This suggests that the end of the recession is at least a year and a half away.

Supporting this view is James Hamilton, the economist on whom the Joint Economic Committee of Congress relied on for its recession probability study. He does not see the recession ending until August 2009, and the job market (which is what the Fed cares about) not turning up until March 2010. He suggests the U.S. still has another 4-5 million jobs to lose until that upturn. If that is right, that would mean a cumulative employment loss of 4-5%, making this recession more than twice as severe as the last downturn, and a point or two worse than the 1981-82 recession. You'd have to go back to the 1948-49 recession to match those statistics.

The economy still has a long way to go before it can purge itself of a generation of overindulgence. As a result, the bear market is not yet ready to go into hibernation. Although the end of the recession is not yet in sight, we are at the end of the beginning. In this environment, our bias going forward is to be neutral to slightly short on duration, to spread our maturities across the curve and to add credit if attractive risk/reward opportunities present themselves.