

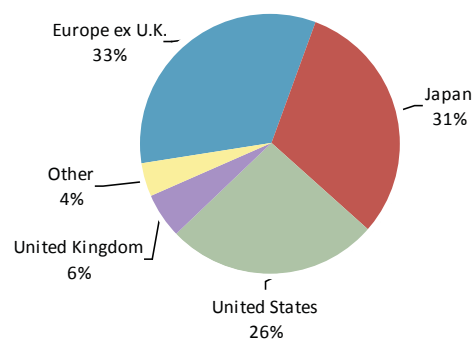
## INTERNATIONAL FIXED INCOME

The globalization of financial markets has led to a deepening of investment opportunities outside of the U.S.

Over the past several decades, global fixed income markets have seen significant advancements; today there are more than 100 countries with partially or fully functioning fixed income and/or currency markets. Today's global fixed income market provides a wide opportunity set for investors, as non-U.S. bonds make up over half of the marketplace. The pie chart below represents the breakdown of the Citi World Government Bond Index, a widely used global fixed income benchmark. As you can see, the U.S. represents only about 26% of the index; 20 years ago, it represented roughly half of the index.

While the investable universe is vast and complex, a portfolio that includes an allocation to international bonds offers investors important diversification benefits. International bonds have historically exhibited low correlation to other traditional asset classes (for example, domestic fixed income and equities); different countries' bond markets have varying degrees of correlation with one another, adding an additional layer of diversification. Due to the impact of currencies and other factors affecting global bond markets, returns for different bond sectors and countries can vary widely. As shown in the exhibit below, the best performing government bond markets have varied from year to year. By maintaining a global perspective and diversifying their

Citi World Government Bond Index  
By Region as of 5/31/2011



Source: Citigroup

### Top 10 Performing Bond Markets

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Poland 30.4%	Norway 40.9%	Australia 37.3%	Poland 36.0%	Mexico 21.3%	Poland 18.0%	Canada 23.8%	Japan 27.8%	Indonesia 40.1%	Australia 19.8%
Philippines 25.3%	New Zealand 37.0%	New Zealand 33.7%	Norway 18.0%	Philippines 19.5%	Sweden 17.2%	Poland 19.9%	Switzerland 15.9%	New Zealand 25.9%	Mexico 19.3%
U.S. 6.7%	Switzerland 35.1%	Canada 29.1%	Sweden 17.4%	Canada 9.8%	Philippines 16.6%	Norway 18.9%	U.S. 13.9%	Australia 25.6%	Japan 17.5%
Norway 3.9%	Sweden 31.2%	Sweden 27.0%	Eurozone 16.0%	Indonesia 9.6%	South Korea 15.8%	Australia 15.5%	Taiwan 8.7%	Norway 24.6%	Thailand 17.4%
Greece 2.0%	Greece 30.1%	Greece 25.6%	New Zealand 15.9%	Malaysia 4.9%	Indonesia 15.7%	New Zealand 13.4%	Singapore 7.1%	Philippines 22.2%	Malaysia 16.4%
Switzerland 1.3%	Denmark 29.2%	Denmark 25.1%	Greece 15.7%	U.S. 2.8%	U.K. 14.6%	Greece 13.3%	Denmark 5.5%	Mexico 15.8%	New Zealand 14.7%
Canada 1.2%	Eurozone 29.1%	Eurozone 25.0%	Denmark 15.7%	Taiwan 2.3%	Malaysia 13.0%	Denmark 13.1%	Eurozone 4.0%	Canada 15.7%	Switzerland 14.6%
Denmark 0.7%	Poland 23.7%	Norway 15.7%	Canada 15.4%	New Zealand 1.1%	Singapore 12.5%	Eurozone 12.9%	Malaysia 3.3%	U.K. 11.4%	Philippines 13.3%
Eurozone 0.6%	U.K. 21.1%	Philippines 14.0%	Switzerland 14.7%	Poland 0.6%	Greece 11.9%	Singapore 12.3%	Thailand 1.7%	Sweden 9.4%	Singapore 12.2%
U.K. 0.4%	Australia 20.5%	U.K. 13.5%	U.K. 14.3%	South Korea 0.4%	Denmark 11.6%	Malaysia 9.9%	Greece -3.8%	South Korea 9.3%	Canada 12.0%
Citi WGBI -1.0%	Citi WGBI 19.5%	Citi WGBI 14.9%	Citi WGBI 10.3%	Citi WGBI -6.9%	Citi WGBI 6.1%	Citi WGBI 10.9%	Citi WGBI 10.9%	Citi WGBI 2.6%	Citi WGBI 5.2%

Source: Morningstar Direct

fixed income allocations, investors can capture the benefit of differing monetary policies and economic conditions throughout the world.

A single-market fixed income portfolio takes advantage of an investor's views on the direction of interest rates or a given bond sector. A globally diversified investor seeks to exploit country-specific differences by taking advantage of expectations for *interest rates*, *currency*, and *credit* movements. These three factors have historically been the primary drivers of return

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## THREE KNOWN UNKNOWNNS

The U.S. equity market has been volatile since late April. There are three major issues weighing on investors' minds that will not be fully resolved for at least the next several months. This suggests continued volatility. These concerns are: the resolution of the U.S. debt ceiling issue in early August; the end of the Federal Reserve's second round of quantitative easing, or QE2; and an uncertainty as to whether the recent poor U.S. economic numbers in employment, housing and manufacturing are temporary or a sign of further weakening to come. If there's further weakening, are there positives to help offset the potential weakness? Let's look at these so we can sort them out in order to frame our approach to the markets.

### Deficits, Debts and Defaults

As we watch the Greek tragedy play out in the European Union theatre, we wonder how our Washington politicians will handle the upcoming negotiations to raise the U.S. debt ceiling, which now stands at \$14.3 trillion. This number represents the amount of debt Congress has authorized the U.S. Treasury to issue to meet the federal government's ongoing obligations.

Political posturing and dire warnings have been made on all sides, including those who say if we run out of money to run the government on August 2<sup>nd</sup>, the bond markets will be in disarray. But the government has been here before. Treasury has numerous options to avoid defaulting on the debt, including "extraordinary" measures such as disinvesting the Civil Service Retirement and Disability Fund, suspending reinvestment in the Government Investment Fund and disinvesting Treasury securities in the Exchange Stabilization Fund. These were employed five times over the past 15 years. Beyond these measures, the Treasury has the power to prioritize payments, steering money to service the debt. In 1957, Treasury delayed payments to contractors, and in 1996 Treasury had planned to delay Social Security payments. There is a 10-to-1 ratio of income received to interest payments to pay for the Treasury, so there is a substantial cushion.

In a May 14, 2011 *Wall Street Journal* interview, Stanley Druckenmiller, a noted money manager who handled the successful shorting of the British pound in 1992 for George Soros, is philosophical about a possible default. He states, "People aren't going to wonder whether 20 years ago we delayed an interest payment for six days. They're going to wonder whether we got our house in order." He believes the short-term market disruption that may occur due to default will be worth it if we really can reduce our profligate spending and debt levels.

He recognizes that even a technical default of missing an interest payment would be negative, "it won't be catastrophic." Some forecast

that the S&P 500 might sell off 10% to 20%, depending on where the index is when this happens. Others point out that the rating agencies may downgrade the U.S. credit quality from its current AAA level and that will sharply increase our cost of borrowing to meet our operating needs. But such a downgrade has already been threatened by Moody's if we do not address our deficit spending and our debt levels.

Our sense is that the risk of a default by the U.S. remains very low. The Treasury market telegraphs this, too, with ten-year yields near 3%, having fallen from 3.77% earlier this year. Will Washington seize the day and fix our looming debt problems with significant cuts, as Mr. Druckenmiller hopes? We think politicians will avoid resolving the issue. Rather, they will "extend and pretend." The debt crisis will be put off until after the 2012 election.

### The End of QE2

On June 30, 2011, QE2, where the Fed actively purchases bonds in the marketplace, thus pushing up prices and driving down interest rates, is scheduled to come to an end. Popular investor psychology has associated QE2 with the market advance that started in late August 2010 and ran through February 2011, causing the U.S. stock market to rally over 20%. But was this rally due to QE2 or to an underlying improvement in economic conditions? Actual QE2 did not start until early November 2010 and it continued to the end of the first half of 2011. Thus, its inception lagged the rally's start by more than two months and it did not prevent the recent market correction in May.

Chairman Bernanke was so concerned last summer about the twin risks of a double-dip recession and deflation that he announced QE2 in late August, even though the monetary stimulus wasn't going to start until mid-November. This may have played to market psychology, but early signs of an economic recovery were also showing themselves in the bond market with increased inflationary pressures and in the manufacturing sector with higher industrial material prices. Was QE2 really necessary? It was clearly not the only reason why the stock market rallied strongly through the balance of 2010 and into early 2011.

Similarly, QE2 continued through to the end of the first half of 2011. Yet, signs of the economy beginning to slow were already evident by mid-February, as industrially sensitive commodity prices, including copper, topped out. The rational observer has to ask just how centrally important the Fed's monetary policy was to really generate the investor enthusiasm and economic strength that caused the stock market to rally into last winter. A reasonable conclusion is that the Fed's actions were perhaps additive, but on the margin. The underlying forces of the business cycle were the real drivers.



## NEWS AND NOTES

### The Economy

Keep in mind that we have been in a secular bear market for the past ten years and that we have just experienced the popping of a second asset bubble, the housing market, during this bear market. Historically, the financial crisis that ensued takes five to ten years to cure since the crisis is often brought on by high levels of indebtedness and valuations. Individual and government balance sheets are still burdened by debt.

If we look at 2011 in this context, we see an economy still plagued with high unemployment. The ability of consumers to take on debt, which often helps fuel a recovery, is nil. The brief manufacturing recovery we enjoyed late last year and earlier this year is slowing down. In fact, many of the drivers for the current downturn in the economy started to be seen in the leading indicators last winter, before \$4.00 gas or the Japanese earthquake.

Many observers believe the economic slowdown is transitory. They forecast U.S. GDP to slow in the second quarter, and then rebound for the second half of 2011. We see continued slowness through 2011 and into early 2012 based on a global slowdown in the manufacturing cycle and significant slowing in the developed nations' economies. The emerging markets will slow as well, but their economies should remain more strongly positive.

We do see several positive developments. With slowing global economies, raw material costs and inflationary pressures should come down. This will keep corporate margins high. Corporate balance sheets remain cash-rich, which will support mergers and acquisitions. Corporate insiders became more bullish as the market corrected in May, suggesting that these current equity prices may be attractive. Finally, the U.S. Treasury has succeeded in lengthening the average maturity of its debt to more than five years, the longest since 2002, by taking advantage of the current low interest rates. This will buy the U.S. time in getting its fiscal house in order.

### The Markets

In spite of these positive notes, we remain defensive given the above concerns as well as other issues. Because corporate profits should stay strong as inflationary pressures subside, equities remain an important part of our portfolios. We have not overweighted them in this environment. The emerging markets have underperformed over the past six months and may represent selected opportunities. As the Fed pulls back from QE2, we remain short on our bond maturities. Global bonds are an important component of our bond commitment. Our use of alternatives continues to be important, as we find long-short strategies and merger arbitrage to be rewarding. Commodities have become increasingly important in our portfolios as we seek to take advantage of mispriced currencies, food, energy and materials and of heightened volatility. ■

### ○ | **Thanda Fields Brassard Addresses ABA Conference**

In April Fiduciary Trust attorney Thanda Fields Brassard spoke at the Spring Symposia of the American Bar Association Section of Real Property, Trust & Estate Law. Trust, estate, and real property attorneys from across the country gathered in Washington, D.C. to discuss the latest legislative, judicial and regulatory developments. Thanda presented on the topic of Estate Planning for Non-Traditional Families.

### ○ | **Roth IRA Conversions**

As highlighted in the Fall 2009 *Fiduciary Perspective*, anyone can now convert a traditional IRA to a Roth IRA. If you would like a reprint of this article, please speak with your investment officer or visit the Publications and Announcements section of our website ([fiduciary-trust.com](http://fiduciary-trust.com)).

### ○ | **Gifting Opportunity**

In addition to the \$13,000 annual exclusion gifts and gifts made to providers for medical costs or tuition, the 2010 Tax Relief Act allows individuals to gift up to \$5 million during their lifetimes without incurring a federal gift tax. Under current law, this opportunity will sunset on December 31, 2012. Although it is not yet clear whether this opportunity will be extended beyond 2012, or how large lifetime gifts made during 2011 and 2012 will be treated in estates of those dying after 2012, this may be an opportunity to consider in your overall wealth transfer planning. Please speak to your investment officer if you would like more information.

## INTERNATIONAL FIXED INCOME *(continued from page 1)*

(and consequently, sources of risk) for international bond investors. When assessing investment opportunities, each of these three potential sources of return can be isolated to help ensure that the most attractive overall return is achieved.

The first tool at a global fixed income investor's disposal is managing the portfolio's duration. Duration is an approximate measure of a bond's sensitivity to changes in interest rates. Bond prices tend to move in opposite directions from changes in interest rates. That said, the lower the duration, the less sensitive a bond (or portfolio of bonds) will be to changes in interest rates. A global fixed income manager can add alpha (a measure of risk-adjusted excess return) by correctly anticipating the direction in which interest rates will move and positioning the portfolio's duration accordingly. For example, if interest rates are expected to rise, it would be beneficial to shorten a portfolio's duration, potentially minimizing the impact of changes in rates.

A global fixed income portfolio can also be positioned to take advantage of currency fluctuations. Generally speaking, a currency can appreciate (versus another currency) due to a lower relative rate of inflation, or a more restrictive monetary policy. A country with a higher level of interest rates will generally attract more foreign capital, which will cause the currency to appreciate. The appreciation or depreciation of a foreign currency relative to the domestic currency will have a direct impact on the bond's value when the foreign bond price is translated into an investor's domestic currency. For example, if the U.S. dollar depreciates against a foreign currency, the international bond's interest and principal payments paid in that foreign currency can be exchanged into more U.S. dollars, thereby improving the bond's return. On the other hand, if the U.S. dollar appreciates versus a foreign currency, the bond's interest and principal payments in the foreign currency are worth less when translated into U.S. dollars, thereby reducing the bond's return. Identifying economies with positive growth dynamics, low inflation, and fiscal sustainability can lead to capturing the incremental returns from countries with appreciating currencies.

A country's credit rating estimates the country's ability (and willingness) to repay debt. Typically, a rating assesses the creditworthiness of a government's debt. A poor credit rating indicates more vulnerability with a higher risk of default, and therefore, investors will demand a higher interest rate to be compensated for taking on this additional risk. The credit quality of international bonds can vary substantially. Historically, government debt issued by many developed countries typically has had stronger credit ratings than debt from emerging market countries. Emerging market economies often have less political stability and less developed capital markets. As a country's capital markets mature and credit rating improves, the level of interest rates may decline (due to the lower perceived level of country-specific risk), leading to the appreciation in the bonds issued by that country's government.

As the global fixed income markets continue to develop and mature, it is important for investors to maintain a truly global perspective when investing. Having historically exhibited low correlation with other asset classes, an allocation to international fixed income can help to reduce overall portfolio volatility. Using in-depth macroeconomic analysis, investors can assess the relative attractiveness of individual countries with regard to economic conditions, monetary and fiscal policies, and political stability, among other factors. By expressing and implementing positive and negative views on interest rates, on currencies, and on credits, astute investors can exploit country specific differences and benefit from varying economic conditions and monetary policies worldwide. Allocating to international bonds can smooth out portfolio volatility while providing the opportunity for higher returns. ■

By Deirdre A. DeRosa CFP®, Financial Analyst

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