MARKET COMMENTARY

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2010: A Year of Transition for the Bond Markets

Uncertainty About the Success of the Fed's Exit Strategy May Create Opportunities Through Market Volatility in 2010

After 2009's amazing rally in corporate bonds and general sell-off in Treasuries, we anticipate that the most successful bond fund managers for the balance of 2010 will be those who can select the individual securities that are best-positioned to outperform in an environment of continued uncertainty and volatility. The ability to nimbly trade to take advantage of mispriced bonds will also be essential for success this year.

Uncertainty Abounds

In 2010, central banks around the world will begin to rein in the excess reserves that they added to the banking system in 2008 and 2009 in their attempt to support the financial system. There is significant uncertainty about how quickly central banks will be able to accomplish this task, as well as how successful the actions will be in terms of not throwing the nascent economic recovery off track. Another element that adds to the uncertainty surrounding the bond market in 2010 is the fact that U.S. midterm elections take place in November. As a result, politics will increasingly influence U.S. fiscal and monetary policy for the remainder of the year.

Bond markets tend to be uncomfortable with uncertainty as investors and traders search for a clear reading on the direction of interest rates, yield premiums on corporate bonds, and other factors. However, this uncertainty isn't necessarily a bad thing. It also tends to create volatility in the market, so investors who strive to profit from volatile conditions should be well-positioned to benefit this year. In addition, credit analysis and individual security selection becomes increasingly important in a volatile market where particular bonds can temporarily become mispriced.

In contrast, some of the bond market trends of 2009 were so pervasive that, in some cases, the credit quality of individual bonds almost didn't matter. For example, high-yield bonds—particularly those with the lowest credit ratings in the high-yield sector—performed amazingly well in 2009, with the BofA Merrill Lynch High Yield Master II Index returning more than 57% for the year. To post relatively large returns in 2009, bond fund managers simply needed to overweight the right sector and hold onto it for the year. In 2010, however, we anticipate that volatility and uncertainty will make fundamental credit

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analysis at the individual security level a much more significant predictor of success.

Future Fed Policies Weigh on Markets

One of the biggest questions for the U.S. economy in 2010 is when the Federal Reserve (Fed) will begin to increase the target federal funds rate, which is the rate that banks charge each other to borrow reserves, and how quickly it will tighten monetary policy after it starts. In February, the Fed made the first subtle move toward tightening monetary policy by increasing the discount rate, which is the rate that the Fed charges banks to borrow from its "discount window."

The Fed has also announced that it will stop some of its quantitative easing, which involves buying securities such as Treasuries and mortgage-backed securities (MBS) on the open market to add more reserves to the system. We believe that the Fed will raise the federal funds target rate sometime before late 2010, but in terms of quantitative easing it may be difficult for the Fed to completely stop buying MBS without risking a further downturn in the housing market. It is entirely possible that the housing market may require further government support, so the Fed may ultimately wind up extending or restarting its MBS purchases.

Government Debt Levels Cause Sovereign Concerns

According to a recent McKinsey Global Institute study, six to seven years of slow economic growth have historically followed periods of overleveraging, such as the time period leading up to the subprime mortgage crisis that began late in 2007. Consumers are deleveraging, so the lack of an increase in consumer spending will likely continue to weigh on economic growth in 2010. In contrast, most governments have not yet started to deleverage—the hangover from the U.S. government's debt-fueled economic stimulus programs will continue for years in the form of cutbacks in spending and possible tax increases. The Treasury Department issued $1.5 trillion in new debt in 2009. The McKinsey study cites Global Insights estimates showing that U.S. government debt will jump to 105% of gross domestic product (GDP) in 2012 from 60% in 2008.

The problem of excessive government debt is certainly not limited to the United States. Already in 2010, market concerns about Greece's debt and deficit levels have triggered a sell-off in the country's sovereign bonds, causing other countries that share the euro currency to say that they will provide financial backing to Greece if necessary. We believe that the issue of sovereign credit problems for various countries could continue to weigh on economic growth and bond markets to varying degrees throughout 2010.

No Double-Dip Recession

Unlike some economic forecasters, we don't foresee a double-dip recession. We do anticipate that the economic recovery will continue in 2010, although it will be slow in comparison to recoveries in the past and likely somewhat uneven. However, the unemployment rate will probably stay at a relatively high level through the end of the year. Again looking at a historical economic recovery, it took five years for the unemployment rate to drop from 10% to 5% in the 1980s, and the rebound in employment from the most recent recession could be just as lengthy.

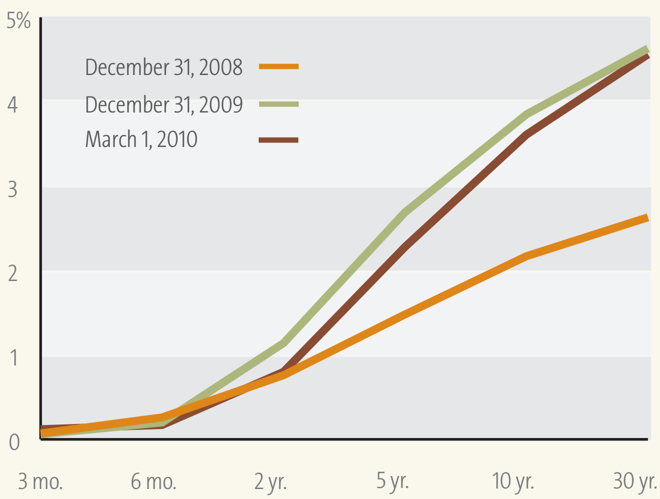
Again, unlike some economic forecasters, we don't believe that consumer or producer price inflation will be a major concern in 2010. We anticipate that the Fed will have enough warning of impending inflation to take action to head off any problems with pervasive price increases. The Fed also has monetary policy tools that it can use to control inflation. For example, the Fed can raise the interest rate that it charges on excess bank reserves, which would help slow any excessive lending that could lead to inflation. Looking beyond 2010, however, inflation could become a problem simply as a result of the government's enormous debt and borrowing needs.

Flatter Yield Curve by End of 2010

In terms of the level of Treasury rates and the shape of the yield curve in 2010, we foresee the government continuing to issue record levels of new Treasuries over the course of the year in order to fund its ongoing economic stimulus spending. This new Treasury supply should push longer-maturity Treasury yields higher. When the Fed does begin to raise the federal funds rate, shorter-maturity Treasury yields should climb significantly. Overall, we foresee a flatter Treasury yield curve by the end of 2010. Incidentally, the yield difference between two- and ten-year Treasuries reached a record high of 291 basis points[1] on February 22, so the market's natural tendency for the remainder of the year should be to move toward a flatter yield curve that fits better with historical norms.

RECORD STEEPNESS OF TREASURY YIELD CURVE

The difference in yield between the two-year and ten-year Treasury notes hit 291 basis points in late February, marking a record-wide steepness between the two maturities.



Source: Bloomberg

We obviously don't expect anything like the tremendous rally in corporate bonds that took place in 2009 to happen again in 2010. Corporate debt issuers apparently are thinking along the same lines—the volume of new corporates issued in January reached an all-time monthly record as companies rushed to raise funds by selling new bonds at relatively low cost (relatively low interest rates). In addition, companies likely turned to the corporate bond market to raise capital because most large banks are still generally more hesitant to lend than usual. However, credit spreads[2] have widened somewhat in early 2010. This is a possible indication that the window for companies to cheaply raise capital in the corporate bond market may be closing.

In comparison with corporate bonds, the MBS sector stayed afloat in 2009 primarily as a result of the Fed's MBS purchase program. The Fed has said that it will stop its open-market purchases of MBS in 2010. Because many "natural," non-government buyers of MBS fled the market when the extent of the subprime mortgage problems became apparent in 2007 and 2008, the end of the Fed's MBS purchases will likely leave the market without significant demand, hurting prices. Interestingly, because many investors who sold MBS holdings to the Fed used the proceeds to buy Treasuries, the end of the Fed buying in the MBS market could also result in a slight decline in demand for Treasuries.

Calvert Bond Funds Positioned for Opportunity

Given our outlook for higher interest rates later in 2010, we plan to continue to keep the durations[3] of our taxable bond funds shorter than the durations of their respective benchmarks. This should help minimize the negative effects of rising rates. The large amounts of new Treasury supply reaching the market, combined with the possibility that foreign central banks could slow their purchases of Treasuries, make a conservative duration positioning the ideal for 2010 from our point of view. In addition, we will position our Funds to take advantage of a flattening yield curve, and we will continue to look for opportunities to actively trade Treasuries and Treasury futures in volatile markets.

The key to successful corporate bond investing in 2010 is likely to be rigorous credit analysis and strong individual security selection. We feel that our team of credit analysts is strong and will give us an advantage in analyzing future cash flows, debt maturity schedules, and other factors that contribute to the overall credit quality of individual corporate issuers. Also, we anticipate that a gradual widening in credits spreads in 2010 should provide opportunities to selectively add to some corporate bond positions on weakness, as well as to actively trade corporates to take advantage of volatility.

Floaters and Some High-Yield Bonds Still Attractive

Within the very broad corporate bond sector, there are some types and categories of bonds that we think could be particularly attractive as holdings in 2010. Floating-rate notes (which government-related entities also issue), for example, offer protection from the risk of rising interest rates in addition to exposure to an issuer's credit. Because the coupon payments on floating-rate bonds automatically adjust at regular intervals in lockstep with a benchmark rate, interest payments on floating-rate holdings would increase as market rates increase.

Also, despite 2009's phenomenal rally in high-yield corporates, we feel that there is still room for gains in the values of some high-yield bonds in 2010. This is particularly true for bonds in the higher credit quality categories within high yield in general. In addition, the high coupon payments on high-yield holdings can contribute significant income to a portfolio. In a positive sign for high-yield bonds in general, the market's expectations for high-yield default rates have dropped significantly from around 10% in early 2009 to between 4% and 6%.

Finally, we will likely continue to avoid the MBS market in 2010, especially since the government looks ready to remove the sector's life support through Fed purchases. However, we do think that there are some asset-backed securities (ABS) that could perform well in 2010. Assets such as credit card payments and student loan receivables back ABS, in contrast to mortgages for MBS. New ABS issues have been reaching the market without government support, which is a positive sign for the sector.

Active Trading and Credit Analysis are Keys

We expect bond market conditions for the balance of 2010 to lend themselves to active trading on volatility and to credit analysis of individual securities, both of which we consider to be strengths of Calvert's taxable bond portfolio management team. We anticipate that the uncertainty surrounding the Fed's "exit strategy" from its extremely accommodative monetary policy during the credit crisis will both create volatility and prevent strong sector trends from developing as they did in 2009. Despite the risk that the Fed's end to quantitative easing will tip the housing market back into decline, we are looking forward to striving to pick the bonds that offer the most relative value and to actively trading to try to profit from mispriced securities. ■

1. A basis point is 0.01 percentage points.

2. Credit spreads measure the difference in yield between a corporate bond and a Treasury security with a comparable maturity.

3. Duration measures a portfolio's sensitivity to interest rate changes. Generally, the longer the duration, the greater the change in price in response to a given change in interest rates.

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