

4th Quarter 2009 Portfolio Manager Market Commentary  
Thornburg Corporate and Government Bonds



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#### Ability and Willingness

An investment theme that I believe is worth watching over the course of the next several years is the likely deterioration of sovereign credit quality throughout the developed world. While it is more the purview of the tin foil hat crowd to discuss the imminent downfall of the U.S., when I look across the globe at countries in various states of fiscal and monetary disarray, I must say that I'm tempted to reach for a scrap of reflective material.

Clearly, the U.S. government has moved strongly towards a position that larger government interaction with markets is to be encouraged, and more broadly towards the idea that the government is the best solution to many problems. Gone are the days of Ronald Reagan's famous joke about the most terrifying words being: "I'm from the government, and I'm here to help." These days, we are instead rightly angry with the failure of private enterprise to survive without government intervention.

At the same time, we were and are unwilling to contemplate a world in which failure creates potentially destabilizing chaos. Ludwig von Mises, a somewhat divisive economist of the Austrian school, once said: "There is no means of avoiding a final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved."

Unfortunately, nearly every developed market currency system has been involved. It is natural in a recession to increase government debt levels in response to lower GDP (and therefore taxes) and higher expenditure (Keynesian stimulus and the like). We have gone a long way down this road and have maintained a certain level of leverage in the financial system if only due to extraordinary efforts by the Federal Reserve and various central banks around the globe. Is it the right thing to do? It clearly avoids near-term pain and adjustments. Ben Bernanke has made a study of the Great Depression and has concluded that then-Treasury Secretary Andrew Mellon's prescription to "purge the rottenness out of the system" through liquidation was as foolish as it was then unpopular. Further, Bernanke has clearly repudiated Mellon's belief that "weak" banks needed to be weeded out. Bernanke's belief is that the Great Depression was extended and deepened by the withdrawal of credit from the system, and he has predictably ensured that credit has continued to flow by any means necessary to include his now-famous prescription for throwing money out of helicopters.

So unfortunately, we are in the middle of a great experiment. The Depression Era was clearly not a success, though it will be endlessly argued whether this was due to the Mellon liquidation approach or a continuous stream of Rooseveltian New Deal stimulus. Now we will try the Anti-Mellon, Anti-von Mises

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route which will be the socialization (loaded word, but correct in its basic form) of debt from individuals and corporations into government. This process is occurring to a greater or lesser extent across the globe, with some countries (notably China) more appropriately structured for such centrally planned economic change. One interesting aspect to this experiment is that the socialization of debt is most extreme in geographies that had the most extensive credit systems (developed markets) and makes the underbanked, underleveraged, resource (natural or labor) rich BRIC countries look so much better.

The big problem with these bailouts is that the amount of debt hasn't gone anywhere, and it is the amount of debt (relative to productive capacity...a ratio that can broadly be described as leverage) that is the true problem. Who can argue that when an entity takes on more debt, it becomes less creditworthy and more inclined toward failure? When governments take on more debt, it certainly follows that they will be less able to pay, and when individuals feel no particular responsibility towards a government, the willingness of that government to pay comes into question.

Greece is only the latest example of a government that has increased its expenditures in the best of times and, in the worst of times, is having trouble with its new and increased debt load. The more profligate countries of the EU (Portugal, Italy, Ireland, Greece, and Spain to name a few) are the standouts in this region (in direct contrast to the bastion of rectitude that is Germany). Dubai seems to be fading from our memory with the application of some significant petroleum salve from Abu Dhabi. Iceland is in the middle of the North Atlantic and is yesterday's news anyway. There are structural problems with Japan given that their traditionally high savings rates may be eroded by a demographic nightmare, and an increase in rates paid by the government on its debt may be untenable given the sizeable obligations that nearly three decades of stagnation have incurred. The U.K. (that former financial miracle) and the U.S. are not in wonderful shape either. How much more debt can the global financial system support?

Not surprisingly, given that debt is part of the problem, looking at the global debt universe doesn't give me comfort. Taking the Barclays Capital Multiverse Index (it's the broadest characterization of debt markets globally), the USD represents 41.57%, the Euro is 29.21%, the Yen is 16.7%, and the Pound is 5.21%. For those of you without a calculator, that's 92.5% of the total available universe. Sure there are other places to go, but broadly developed markets (and I mean that very much in the sense of places where the markets are developed enough to be easily and significantly investable) dominate the debt universe. It's the classic case of not lending money to institutions that need it.

And we will need more. Barclays Capital (the keeper of the above index), estimates their widely followed Aggregate Index (an attempt at an amalgam of all taxable, dollar-denominated investment grade debt over 1 year in maturity) will be increasingly dominated by Treasuries. In the span of 2010, they estimate that the portion of the index which is comprised of direct obligations of the U.S. government will move from 27.6% to 33.5%. This is in the context of an index which is slated to grow by 18.3% overall. Putting those two figures together, Barclays believes that the amount of U.S. Treasuries outstanding with maturities greater than one year will grow by 43.3% in the span of one year.

Add to this the impending demise of the program of quantitative easing, in which the Federal Reserve bought Treasuries, Agencies, and Agency Mortgage debt in order to keep the costs of borrowing low, and you might start thinking about sharply higher rates. I'm more sanguine about that possibility in the U.S. than in a number of other places (to include Japan) given that we have a wide variety of folks who are now looking for greater stability and income in their investments. Still, supply will be higher, and demand may not keep pace. One more tidbit: Barclays sees one other area of significant debt growth in 2010. The increase of taxable municipal bonds in the index: 2% in 2009 to 5% in 2010. So it's not just the Federal government, but state and local governments as well (though part of this is due to issuance in taxable versus tax-exempt structures).

The investment upshot of this is that I'm trying to stay with creditworthy institutions that might be issuing less, rather than more. Corporate issuance will be lower and given spreads at the moment that sector still looks like the best house in what may be a neighborhood in decline. Away from U.S. centric portfolios, the freedom to move outside the U.S. to relatively healthy economies like Australia (resource-rich, free to raise rates) drives some of our more recent investment decisions. In general, we're trying to buy scarcity. Going forward, I would expect continued headlines and risk arising from government finances, with Venezuela as yet another trouble spot where untenable promises are backed by equally untenable financing and currency arrangements. Though the U.S. is not currently very fiscally responsible, I expect a number of other locales to run into significant issues that will highlight the benefit of responsibility and as such change the (until now) overwhelming Keynesian tide.

Thanks for taking an interest in our funds. I believe that Thornburg's taxable bond offerings have been able to produce consistent investment results in the context of each portfolio's goals, and we will continue to strive for these same outcomes going forward.

### **Important Information**

The views expressed by the Portfolio Managers reflect their professional opinions and should not be considered buy or sell recommendations. These views are subject to change.

The Barclays Capital Multiverse Index provides a broad-based measure of the global fixed-income bond market. The index represents the union of the Global Aggregate Index and the Global High-Yield Index and captures investment-grade and high-yield securities in all eligible currencies.

The Barclays Capital Aggregate Bond Index is composed of approximately 6,000 publicly traded bonds including U.S. government, mortgage-backed, corporate and Yankee bonds with an average maturity of approximately 10 years. The index is weighted by the market value of the bonds included in the index.

**Agency Security** – A debt obligation issued by government corporations or government sponsored enterprises. Agency securities are exempt from state and local taxes. They are not guaranteed by the U.S. government.

**Agency Mortgage Debt** – A mortgage backed security issued by a government agency.

Treasuries are negotiable debt obligations of the U.S. government backed by the "full faith and credit" of the government and issued at various schedules and maturities. Income from Treasury securities is exempt from state and local, but not federal, taxes.

The performance of any index is not indicative of the performance of any particular investment. Keep in mind that indices do not take into account any fees and expenses of the individual investments that they track. You cannot make an investment in any index.

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