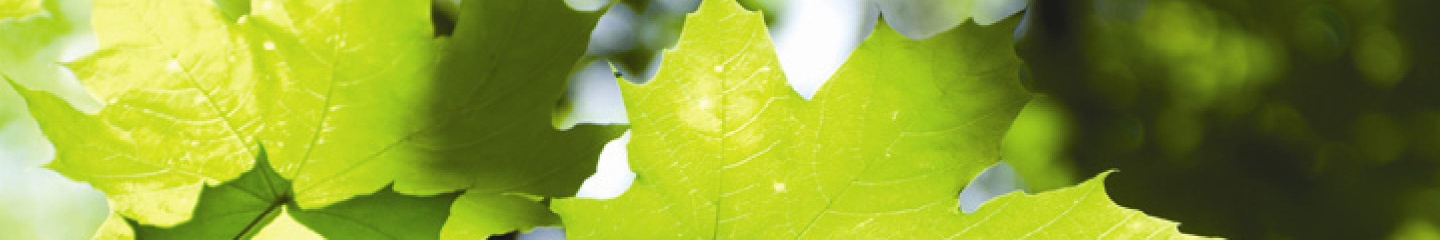

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Fixed Income Commentary | February 2010

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Dealing with uncertainty

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Investors spent most of February looking at Europe wondering how the Greek tragedy would play out. One of the results was a further paring back of risk by investors. This theme of risk reduction is not new, in fact it has been building momentum since November when Dubai World hit the headlines. In my opinion one of the best illustrations of investor risk appetite is encapsulated within the State Street Global Markets Regime Map illustrated below, which is a self-organizing map of cross border institutional equity flows. Each regime represents (historic, by month) cross-border equity flows that are similar, so we can look at the map as a visual representation of investor behavior. Interestingly, from a flow perspective we are at a similar point as February 2009.

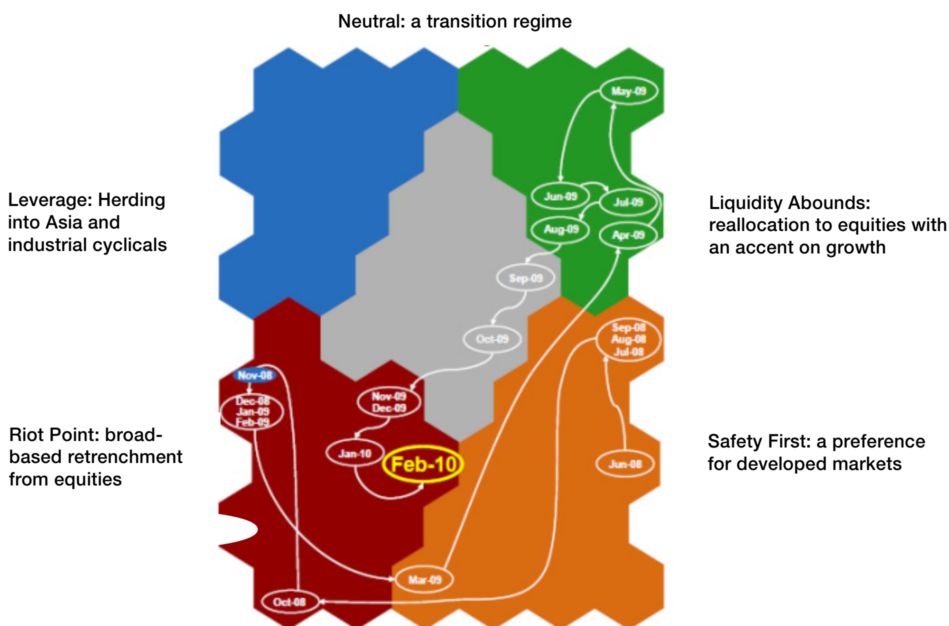
State Street's regime map gives us a look at investors positioning

The regime of Riot Point in the chart represents investor flows that are a broad based retrenchment from equities. Typically, in this period the USD appreciates. The fact that investor flows are still in Riot Point during February, the fourth consecutive month, is significant, as State Street points out, as this is the third longest since 1997. Importantly, the selling by investors in November and December was by and large profit taking at the end of an extraordinary year for risk assets and the near record setting returns in many sectors. However, the escalation of sovereign risk helped the selling trend to persist and become more enduring.

Investor positioning shows that in 2009 amidst monetary and fiscal reflationary policy, risk taking increased

In our view, the obvious question is what will ignite investors to buy risk again? First, let's look back at what happened in March 2009. A series of monetary and fiscal initiatives, the initiation of quantitative easing and the successful passing of the bank stress tests combined with extraordinary historic valuations put investors back into markets. As is typical after a period of Riot Point, investors went for Safety First, which essentially is the buying of developed market equities. When confidence was further restored, investors moved into Liquidity Abounds regime, which is typically associated with the buying of emerging markets.

The Regime Map clusters cross-border equity flows into regime's, providing insight into institutional investor behavior



Source: State Street Global Markets from June 2008 to February 2010

Sovereign risk is driving the current investment climate, a theme that we identify may be long term

So, turning back to March 2010 what will tempt investors back into risk markets? Sovereign risk has become a major theme across financial markets, with several notable academics wading into the debate. The chart below illustrates the facts by plotting the fiscal balance and net debt of the sovereign universe. Here, the fragile position of Greece is clearly evident. More importantly, the chart illustrates that while Portugal, Ireland and Spain are also operating in the danger zone, the UK and the US are not too far away.

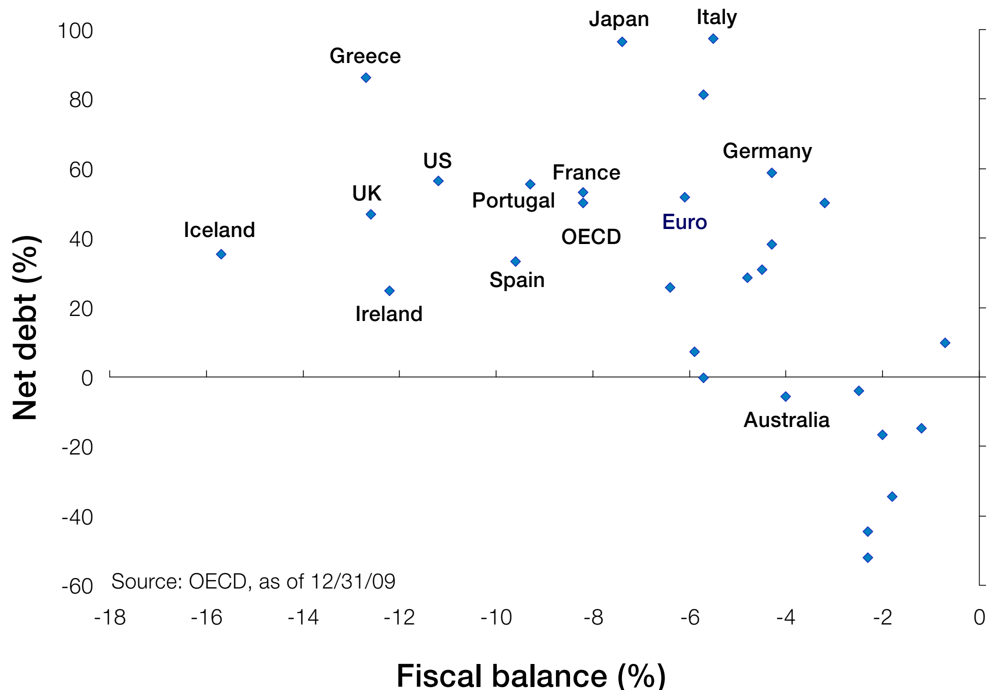
Analysis should not be on Greece, but the long term fiscal conditions of the major countries

The significance of fiscal/debt deterioration beyond what investors find tolerable is simple…..it may result in higher interest rates, that is, investors may demand a higher premium to buy sovereign debt. As I stated last month, it's not Greece, it's the contagion. Greece is the sideshow. The real focus for analysis has to be on the UK and the US, given their size in global financial markets. The UK is being dragged into the spotlight because of the upcoming election (yet to be announced but due by June 3rd) and the risk of a hung parliament – which is being viewed as negative as it complicates any government's attempt to deliver needed fiscal consolidation.

It's about confidence in a country's ability to manage through a crisis

In the UK, sterling has fallen over 10% from mid-January to end February and is down 13% since August. 10 year gilt yields rose over 80bp since the summer. The US has remained relatively bullet-proof to such speculation despite the equally concerning fiscal/debt balance. As I stated last month, it's often about investor confidence. However, the risks are described by Prof. Niall Ferguson (Empires on the edge of collapse, Foreign Affairs, March/April 2010) when he states "empires are complex systems that sooner or later succumb to sudden and catastrophic malfunctions….(and) most imperial falls are associated with fiscal crisis." Evidence of the importance of these conclusions can be seen with the sub-prime problem in mid-2007 in the US eventually bringing the global financial markets to their knees by Q4 2008.

As the credit crisis played out over the past two years, leverage rapidly moved from the private sector to the public sector



Source: OECD, as of 12/31/09

Investors have been de-risking portfolios while the economics improve

As we enter March investors are coming off a four month period of de-risking their portfolios. Yet, against this background, corporate earnings have again beaten expectations (despite absence of real top line growth); macro fundamentals remain constructive; and, despite fears of premature policy tightening, central banks are still treading a very cautious path to normalization.

We have conflicting outlooks that may be driven by confidence in the short term and fiscal health in the long term

This suggests we are facing two potentially conflicting outlooks. One that may dominate in the short term is where investors are tempted back into risk taking – as Greece delivers fiscal austerity against a background of EU solidarity. Or secondly, a slightly longer term theme of sovereign risk rising to a new and higher level if circumstances in the UK and/or the US become elevated – which may result in higher interest rates and potentially a massive shift away from risk assets.

Conclusions

Will 2010 be the year of Sovereign Risk?

2009 has already been marked down as the year of credit. 2010 could be remembered as the year of sovereign risk. The pressure for fiscal consolidation amongst western governments is significant. If not embraced, the risk is financial markets again take control. This may result in higher interest rates. Perhaps a sustained global economic recovery may save the day. The other side of this is the delivery of significant fiscal consolidation under the watchful eye of the market risks tipping economies back into recession (the feared double dip), where investors would wonder what rabbit central banks could pull out of the hat to support risk taking?

We remain overweight credit and underweight duration

Where does that leave our strategy? Our outlook for 2010 embraced two themes: (i) credit remains cheap, but now it's the time for the credit analyst to provide crucial differentiation on security selection; and (ii) Sovereign bonds remain expensive, where we remain on alert for confirmation of a move to higher interest rates. We have gradually increased our allocation to the CMBS market in recent months. This may look at odds with the fundamentals, but here is where careful bottom up name selection holds the key. We remain overweight credit but have reduced our overweight to banks versus corporate positions. In Agency MBS, we reduced exposure and tactically moved down in coupon as the recent buyout announcements and the end of the Fed/Treasury purchases filter through and adjust the market. In terms of duration, we remain strategically underweight and with rates moving towards the middle of the trading range established since June (3.3-4% on the 10 year Treasury) we see limited reasons to take above benchmark durations on a short term/tactical basis either.

We view liquidity as an undervalued resource and maintain it through the strategies

This environment is also conducive to holding a bias toward liquidity in portfolios, a theme Macquarie believes is structurally undervalued by investors. This may enable our portfolios to remain flexible to the challenges we may be facing in the months ahead.

Portfolio Positioning and Strategy

Macquarie Allegiance manages separate accounts, invested in fixed income securities including Government-only, AAA-only and Investment Grade portfolios. Below is a summary of our Investment Committee views at month end.

Strategically and tactically underweight duration

Duration: *Below benchmark*. We are underweight duration as more of a strategic positioning, given our bias for higher rates over the course of 2010. Treasuries remain well within the trading range established since June of last year (3.3-4% for the 10 year Treasury). Our view, with continued improvement in sentiment and expectations, is we may test the top of this range in the first half of 2010, which would be 4% for the 10 year Treasury. While short term rates currently remain well anchored by an accommodative Fed, real rates in the intermediate and long end of the maturity spectrum may rise over the course of the year due to supply/demand pressures, rather than inflation concerns, which remain structurally benign.

Macquarie Allegiance

Fixed Income Commentary | February 2010

Neutral on the curve amidst an accommodative Fed. History tells us the next move may be a flattener

Yield Curve: *Neutral.* While sovereign risk may contain yields in the short term, we believe with an accommodative Fed and supply/demand pressure we may continue to underpin record steepness in the yield curve. Our view of the curve may change with expectations of a tightening of Fed policy, which in our view may see bear flattening as short term rates are adjusted upwards. History has showed us that during the early phases of a tightening cycle, the yield curve flattens significantly. During the 1994 and 2004 tightening cycle's, the yield curve, on average, flattened by 0.83% between the 2 year and the 10 year Treasury (source: Barclays).

Treasuries remain range bound, the key level to watch is 4% for the 10-Year Treasury

Treasury and Agency: *Overweight Treasuries, neutral/underweight Agencies*. We continue to strategically underweight Treasuries and Agencies in favor of higher yielding asset classes (i.e. Agency MBS, Corporate, CMBS). However, short term tactical decisions to reduce Agency MBS exposure (see below) have put us overweight Treasuries at month end. Treasuries are back square in the middle of the trading range, and we remain strategically bearish towards rising rates through 2010. We see real rates rising and inflation continuing to trend lower. In our view, the key level to watch remains 4% for the 10-Year Treasury and at this level, we expect to evaluate a more severe underweight Treasury position.

Announcements by the GSE's have led us to detour in the short term from our up in coupon overweight

Agency MBS: *Underweight.* The GSE Announcement to buy out 120+ days delinquent loans in February has led us to detour from our up in coupon trade and reduce our Agency MBS exposure to underweight. On February 10th, Freddie Mac and Fannie Mae announced plans to buyout loans from MBS that were more than 120+ days delinquent. This acceleration of buyouts has led to an increase in prepayment risk for the next few months as the programs are implemented. In response, we have reduced our exposure to high coupon Agency MBS. We view this as a short term detour from our strategic view that within Government fixed income, high coupon Agency MBS may provide one of the best risk/return profiles. For further information please see our special research paper on the GSE Announcements through our website www.MacquarieAllegiance.com.

Corporate bonds remain attractive and in our view, fairly valued

Corporate Bonds: *Overweight.* In our view, Corporate bonds remain attractive within the Investment Grade universe of fixed income. We remain overweight Corporate bonds and we believe continued macroeconomic improvement leaves the sector in the "sweet spot" while the Fed continues to focus on high stimulus. That said, the period of rapid spread compression may be nearing an end and our focus remains firmly on bottom up name selection for strategy outperformance.

Valuations on CMBS remain favorable, and in our view, their structures overcome weak fundamentals in the sector

Structured Credit: *Neutral ABS, Overweight CMBS:* Rapid spread compression in the ABS sector and relatively low weighting in the Aggregate Index has us favoring Corporate bonds over ABS. We continue to increase our overweight to CMBS securities as the structures of bonds overcomes, in our view, the continued risk of a prolonged commercial real estate downturn. Within CMBS we carry much of our overweight in the AAA senior securities, which in our analysis have favorable total return potential due to structural enhancements and credit support. In addition to senior AAA CMBS, we have found value in selective purchases of mezzanine bonds from seasoned transactions where underlying collateral characteristics and structural integrity warrant.

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