



Sifting through sovereign mess

May was a dreadful month for risk assets: S&P down -9.7%, with financials losing 11% and VIX volatility rising 13 points. Investment Grade and High yield cash credit spreads widened 43bp and 139bp respectively. The US dollar and Gold were key beneficiaries of the flight to quality, rising almost 6% and 4% respectively. With this risk-off positioning by market participants, Treasuries rallied (10-Year Treasury -39bp) and the curve flattened (-20bp) Source: Barclays.

From a US centric point of view the outlook for risk assets remains positive: All economy ISM is at 56.2 (May); car sales were +22% yoy (May); Retail Sales ex-autos & gas were 4.5% yoy (April); and non-farm payrolls are rising 310K on a 3-month average (May). The Q1 earnings season revealed corporates are in good health, the bank system continues to repair and the outlook/guidance is improving, albeit cautiously (Source: Barclays).

The Macquarie scorecard process which evaluates each asset class in terms of valuation, economic environment and technical's – continues to produce strong positive scores for the economic environment (1.85 currently from a maximum of 2.0). This positive picture is supported by the latest Moody's Default Report, issued in the first week in June, which shows global speculative grade default's continue their downward path in May, sliding to 7.5% from 9.0% in April, and down from a peak of 13.5% in November 2009. Moody's default rate forecasting model now predicts, under its baseline scenario, global speculative-grade default's will finish the year at 2.4% and fall to 1.9% a year from now. It is therefore no surprise that when talking to a credit analyst, particularly one covering investment grade, their list of 'invest-able' names has tended to grow longer and the degree of relative comfort is relatively high.

However, the month of May proved particularly difficult for all risk assets. The US Aggregate index returned 0.84% for the month of May and is now up 3.71% year-to-date. However, it has been the performance by US Treasuries that has surprised most, returning 1.71% in May and 3.93% year-to-date. Investment grade credit dropped 0.38% in the month and now just 3.59% year-to-date, below the Aggregate index and US Treasuries (Source for all returns: Barclays). It would be easy to argue the decline in core inflation (to 0.9% yoy in April, source: BLS) was the major driver of the Treasury rally, but this would be simplifying a more general flight-to-safety that has taken place in light of recent events in Europe.

Readers of economic history can look back to several examples of sovereign crisis: Argentina, Russia, Asia to name but a few. However, what we are witnessing at present is on a different scale. Focus for most of the past six months has been on Greece. However, this is simplifying a broader issue that began with a sub-prime debt problem, that rapidly became a western banking problem, that has now evolved into a western sovereign debt problem. Portugal, Ireland, Greece and Spain (hence the anachronism, PIGS) all have significant fiscal/debt issues to resolve. But even this is masking the broader nature of the problem that extends as far as the UK and the US (see chart on next page). The crisis for risk markets that unfolded during May was the fact that financial markets lost confidence in the cure.

Graham McDevitt
Global Head of Strategy
Co-Chief Investment Officer

The US domestic macro and micro picture remains positive

The Moody's speculative-grade default rate continues to fall to 7.5% in May, from a peak of 13.5% in November 2009.

Treasuries outperformed in May and now outperform investment grade credit year-to-date.

Sovereign risk is much more than a problem just for the EU PIGS.



Uncertainty towards the end game in Europe

In early May, responding to ever widening EU sovereign spreads an almost EUR 1 trillion bailout package was unveiled, involving the IMF and ECB support. This was pure shock and awe therapy, drawing comparisons with what the US Treasury and Fed delivered in late 2008. However, the real theme for May was what happened next as dissension of views within the EU, particularly from Germany (and their Bundesbank) increased uncertainty to what the end game would really be for EU sovereign risk. From a risk point of view, this action managed to snatch defeat from the jaws of victory and had investors running for safety. Fixed income investors are rethinking their outlook – gauging the impact of sovereign fiscal consolidation on growth and inflation. **The two conclusions that have come to the for are: (1) slower growth and (2) lower inflation for longer.**

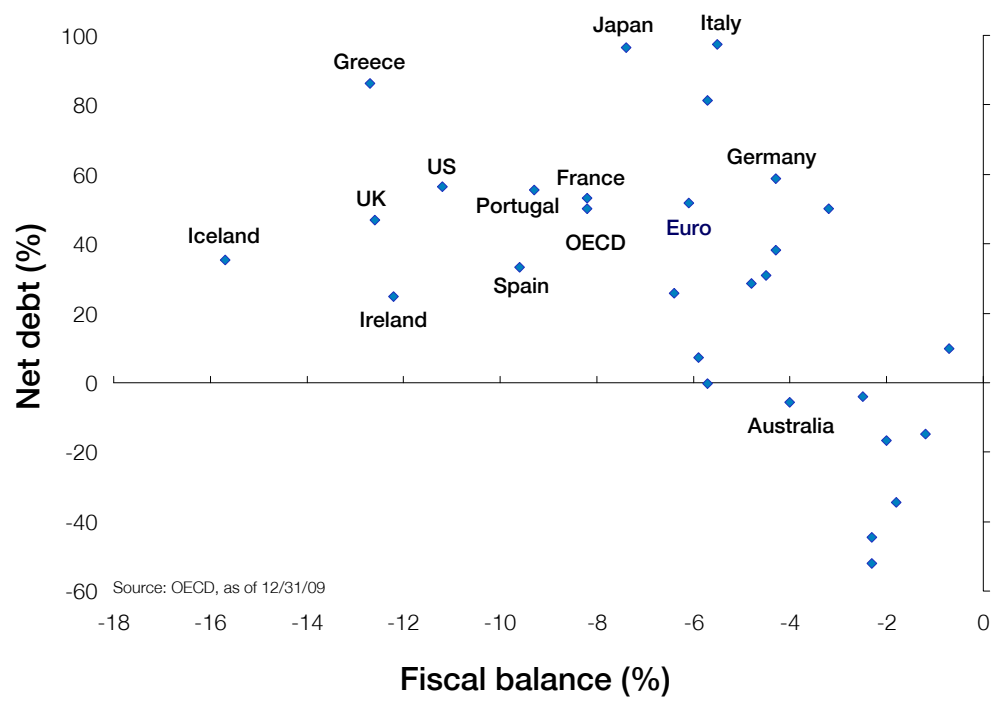
Consensus has moved to expect slower growth and lower inflation for longer

The crisis of 2007-2008 was in part pay-back for a decade of (over) indulgence. Lending standards were too low, leverage too high and focus was on consumption not investment. Faced with a panic and possible collapse in the financial system, sovereign governments responded with a textbook Keynesian stimulus. This was necessary. Its easy for the critics to look back and judge, but the post-Lehman environment was very dangerous. However, what was lost on most government officials was the important fact this action was implemented against a backdrop of already bloated budget deficits and historic high debt levels, particularly right here in the US.

For indebted western sovereign governments there is now no turning back.

The crisis surrounding Greece this year has simply highlighted to all the perilous state of government finances in many western economies. There is no turning back, financial markets now have sovereign debt caught in their headlights. I listened to a EU Sovereign risk conference call a few months back and the most important speaker on that call was the Latin America analyst, who was providing the roadmap that has been used in almost all bailouts of EM sovereign crisis. I noted to the conference providers this was a stroke of genius on their behalf because it needed to be pointed out to all that EU sovereigns need to be judged no differently than Russia, Mexico, Argentina.....the facts are what they are. The medicine is the same. Governments now need to fight for credibility. They need to think five years ahead not one year. The public need to understand the problem. Work needs to be done on the numerator (freezing/cutting spending) and the denominator (underpinning growth) in order to rebuild fiscal metrics.

On this frontier, up and to the left is the wrong direction





Statistically, a double-dip recession has not occurred since the Volker era shocks to the system in the early 1980's

Sentiment is fragile but valuations are fair, for our portfolios smaller risk feels better in this circumstance

A neutral duration is warranted

Sovereign risk aside, history tells us the next move is a flattening of the yield curve driven by a change in Fed policy

Treasuries remain in the range established since June of 2009

Agency MBS remain our favored area of overweight in the Government-only portfolios

It is therefore difficult for analysts/economists not to conclude that the weight of western fiscal/debt consolidation would result in slower growth and lower inflation. Bond yields have fallen, in core Europe to historic lows, though in the US 10-Year yields are still 100bp above their 2008 crisis lows. Equity markets too have adjusted. However, forward EPS estimates imply expectations for recovery extending through 2011 remain strong. Credit markets, particularly high grade corporate credit, have cheapened, but with analysts seeing very low risk of default it has been difficult for the portfolio manager to get too bearish this time. The key risk therefore is economic growth is much weaker than current expectations.....the dreaded double dip.

As we enter June, sentiment remains very fragile. Spreads are drifting wider and the S&P 500 is approaching its technically speaking, double bottom low at 1040 (Feb 5th and May 25th). We have significantly reduced risk in our portfolios in recent months. Smaller feels better at present. We still look at credit as having strong bottom up fundamental support and investment grade credit is back to one standard deviation cheap to historic valuations. However, we will not hesitate to reduce risk further should price action and/or circumstances dictate. We are all wearing our tin hats and dreaming of a quiet summer....but, in reality believe that this nightmare will continue.

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.

Duration: *Neutral.* For the second month in a row we are neutral in duration, with technical and fundamental signals favoring this tactical view amidst Sovereign risk. Longer term we maintain a bearish overall view of rates as high deficits and slow growth may push up real interest rates. In terms of monetary policy, it is difficult for us to foresee an environment where the Federal Reserve raises interest rates in 2010.

Yield Curve: *Flattening.* We entered into yield curve flattening trades in May as technical signals warranted a change from our neutral positioning. The yield curve has flattened through a combination of risk aversion and lower inflation through the last two months. With a on-hold Fed, the short end of the yield curve remains well anchored. A change in Fed policy, while it looks more likely to be in 2011 in our view, may drive a flattening of the yield curve led by the 2-year Treasury. History tells us such. 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).

Treasury and Agency: *Neutral Treasuries, underweight Agencies.* We continue to strategically underweight Treasuries and Agencies in favor of higher yielding asset classes (i.e. Agency MBS, Corporate, CMBS). At the end of May, the 10-year Treasury finished at the bottom of the trading range (3.30%). With Treasuries at the bottom of the trading range, we continue to evaluate higher yielding asset classes, in particular Agency MBS. Since June of 2009, the 10 Year Treasury has range traded between 3.20% and 4%.

Agency MBS: *Overweight.* Two months after the end of the Fed and Treasury purchase programs, Agency MBS as we expected have continued to perform well. As measured by the Barclays MBS Index, the sector has returned 3.30% through May. The end of the Fed purchase plan in March, which was a concern of many market participants, came and went with little impact on valuations or spreads of Agency MBS. A key reason that the end of the program had limited impact on Agency MBS is that the overall environment for the sector remains positive. Valuations in Agency MBS will be driven by its primary inputs; interest rates, volatility and housing market fundamentals. It is within these metrics that we continue to find Agency MBS the most attractive opportunity within Government sectors, in particular due to their highest yields per unit of duration. We favor lower coupons for our beta exposure versus the index and own seasoned high coupon MBS that in our analysis have limited prepayment risk and high cash flow yield.



Corporate bonds on both relative and absolute measures remain attractive

CMBS remain our favored credit sector for overweight's versus our benchmarks

Corporate Bonds: *Overweight.* In our view, Corporate bonds remain attractive within the Investment Grade universe. We remain overweight Corporate bonds albeit we have reduced exposure in May, but maintain a generally favorable view based on relative and absolute measures. Our scorecards remain positive on valuations, albeit technical's lead to caution in the short term.

Structured Credit: *Neutral ABS, Overweight CMBS:* We reduced our overweight to CMBS as part of our risk reduction in May. We continue to maintain a favorable view on the sector and 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.



This communication is of a generic nature, intended for financial professionals and is for informational purposes only. Past performance is not indicative of future results. The opinions expressed are those of Macquarie Allegiance Capital, LLC (“MAC”) as of the time of writing. This document does not constitute an offer to sell or solicitation of an offer to buy any securities or investment services. All information provided herein is subject to change without notice. MAC has used third party sources it deems as reliable, however MAC cannot guarantee their accuracy. Macquarie Allegiance Capital, LLC is not an authorized deposit-taking institution for the purposes of the Banking Act (Cth) 1959, and MAC obligations do not represent deposits or other liabilities of Macquarie Bank Limited ABN 46 008 583 542. Macquarie Bank Limited does not guarantee or otherwise provide assurance in respect of the obligations of MAC.

✉ Macquarie Allegiance Capital, LLC
555 South Flower Street, 33rd Floor
Los Angeles, CA 90071

☎ Client Services
213-233-4500

@ MFGClientServicesLA@Macquarie.com

▶ www.MacquarieAllegiance.com