



Happy bond investors

2010 is shaping up to be a great year for fixed income, following the solid returns of 2009. With yields tumbling and spreads contracting, we evaluate the current environment and what expectation investors should have for fixed income going forward.

Table 1: Total Returns (through September 30, 2010)

Index	September	YTD
CMBS	2.12	19.32
EM Sovereign (USD)	0.11	14.59
High Yield Corporate	3.01	11.53
Corporate	0.70	10.77
Treasury	0.02	8.74
Aggregate	0.11	7.94
Agency MBS	-0.38	5.11

Source: Barclays

Now here is a scary data point for active management....if a fixed income manager simply invested their portfolio in the on-the-run 5-Year Treasury at the beginning of 2010, the total return would be around 10%, through September (Source: Barclays). Look at the table above, the 5-Year Treasury has outperformed the Aggregate, easily. Additionally, the 5-Year Treasury has outperformed every sector in the Aggregate Index, except CMBS (where spreads have collapsed more than 200bps), almost matched the return of the High Yield sector, and compares favorably with the Emerging Market Index if you take account of the significant maturity mismatch.

The 5-Year Treasury yield was 1.28% at the end of September, after starting the year at 2.68% (Source: Barclays). Japan's 5-Year Treasury is at 0.28% so a deflationist could make the case Treasuries still have a long way to fall. Let's assume the 5-Year Treasury does indeed fall 100bp over the next twelve months, the total return would be 5.1% (Source: Bloomberg). This would be a great result, but this total return horizon exercise illustrates the best you can get for Treasuries in the coming year is mid-single digit.

What about Credit, where record inflows continue into bond mutual funds? Spreads on Investment Grade Credit are 160bp as of 9/30 (Source: Barclays). This spread is little changed from the start of the year. The historical average is around 105bp so it is possible that further spread narrowing can help lead to excess returns. Under the same bullish interest rate assumption outlined above, spread compression could generate high single-digit returns from holding Corporate bonds.

So, with forward returns from fixed income looking less attractive, why are investors still flooding the market, putting cash to work and chasing yields ever lower? As James Carville cleverly crafted during Bill Clinton's 1992 presidential election – It's the economy, stupid.

As 2010 progressed the macro data, particularly in the US, has weakened substantially. Macquarie Funds Group Economist, Lewis South, has two ways of looking at the progress of US data through time: Cumulative data momentum and cumulative data surprise.

Graham McDevitt
Global Head of Strategy
Co-Chief Investment Officer

Year-to-date total return for the 5-Year Treasury is 10%

It's getting harder to forecast fixed income returns above single digits

Even in the most bullish case for credit, returns will not keep pace with the record setting run of the past two years

It's the economy

US macro economic data has weakened substantially



US economic data has clearly deteriorated showing why the Federal Reserve is cautious on the outlook

The chart's below compare relative data momentum in the US and Globally. Chart 1 shows US cumulative data momentum (that is, not relative to consensus expectations), has slowed significantly in the June to August period, and stabilized in September. Chart 2 shows that while Data Surprises (meaning how the numbers came in relative to consensus) have deteriorated significantly in the US, Globally data has improved over the time period. These indicators are an important part of our investment process, and clearly illustrate why; Treasury yields have fallen over the past five months and why the Federal Reserve is concerned on the outlook.

But it's the Fed too!

The actions by the Federal Reserve, in our opinion, have also been a significant contributor to lower yields. The Fed has already directly purchased Agency MBS and more recently Treasuries. At the latest FOMC meeting the Fed issued the following statements:

The 'Bernanke put' has driven yields sharply lower since the FOMC statement

"Measures of underlying inflation are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability"

"The Committee will continue to monitor the economic outlook and financial developments and is prepared to provide additional accommodation if needed to support the economic recovery and return inflation, over time, to levels consistent with its mandate."

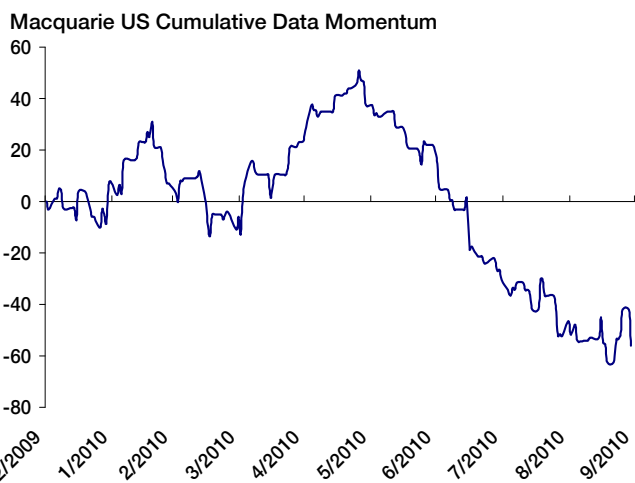
There are some strong assumptions underpinning risk markets

Financial analysts have dubbed these statements as the Bernanke Put, meaning if growth/inflation falls, the Fed will launch Quantitative Easing II (QEII). Many believe the downside is now protected by the Fed as evidenced by the rally in equities, credit and Treasury markets. We would argue there are some big assumptions surrounding this outlook: (i) that QEII will be launched ASAP; and (ii) QEII will work.

Markets are assuming QEII, but we are less certain and note growth remains weak despite massive easing to date

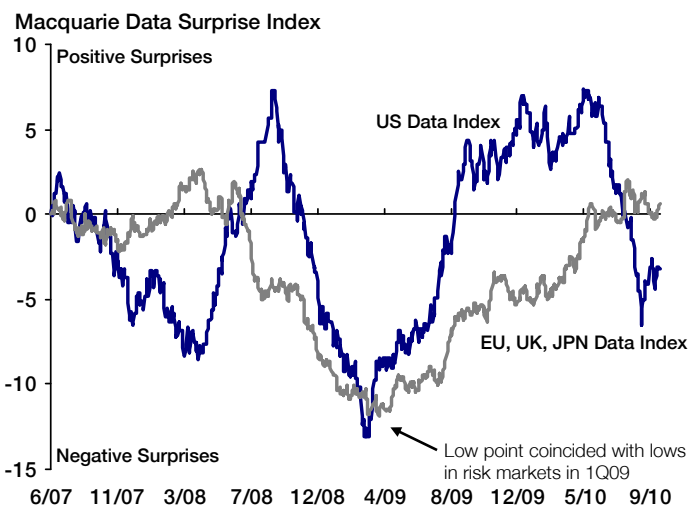
Followers of the various Fed speakers will note there are differing opinions on the need for the Fed to do more to support the recovery. The Boston Fed's Rosengren supports vigorously and creatively using policy options to combat slow growth. Minneapolis Fed President Kocherlakota, despite lowering his growth forecast for 2011 to 2.5%, neither supports or opposes additional actions. Atlanta Fed President Lockart says additional action is not a foregone conclusion. Philly Fed's Plosser says he does not currently support further asset buying because current inflation outlook is not a problem, though he would support aggressive asset buying to ward off deflation.

Chart 1: US data momentum has been weak since June



Source: Macquarie

Chart 2: A divergence in US and Global Data Surprises



Source: Macquarie



We see divisions within the Federal Reserve delaying any QEII

This highlights the divisions within the Fed at present. Thus, we are far less certain than the market seems to be that the Fed will end up undertaking further QE. However, we ourselves see a role for such action (or more specifically credit easing) in helping to support the economic expansion globally.

We have seen record stimulus and quantitative easing, however economic growth is weak and unemployment high

This touches on my second (ii) point above, the assumption that QEII will work. Financial markets seem to forget that massive global easing of both fiscal and monetary policy has been unleashed in the past two years. Despite this, the rebound in US growth is modest in comparison with previous cycles, see chart 3, which is why unemployment remains sticky around 10% and the housing market stuck in the doldrums. Perhaps the Fed should focus on easing credit conditions than printing money.

Investment strategy:

Treasury yields look to remain low for the foreseeable future

Fixed income remains our asset class of choice. With the Fed signaling its willingness to unleash QEII and a faltering growth outlook, Treasuries, we suspect will remain underpinned at the current low yields. With sound credit fundamentals, credit should continue to provide attractive yield.

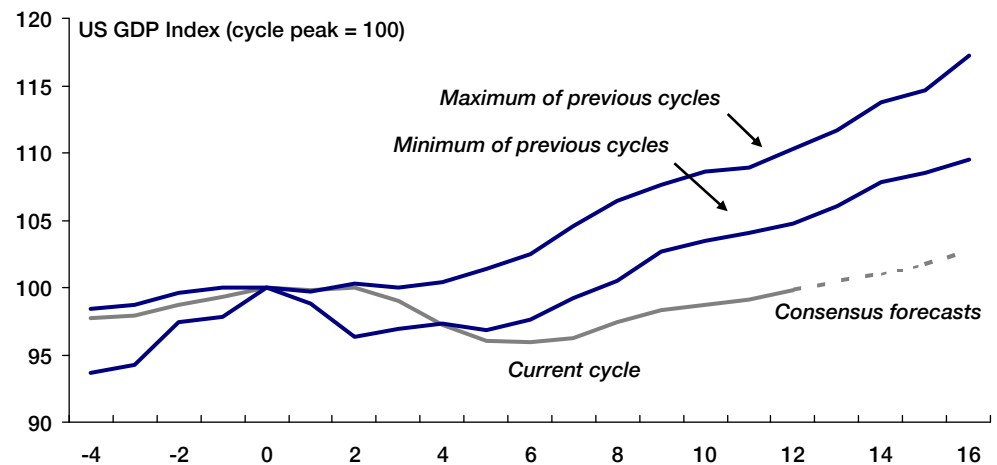
Investors need to manage expectations

That said, with yields now at historic lows and spreads not too far from historic averages the outsized returns from fixed income will be increasingly limited going forward. With investors chasing yields we are amazed to hear how covenant-lite transactions are now going through, akin to the days of 2006. We therefore think it is important to remind our investors that we aim to provide clients with attractive returns consistent with their objectives and expectations, and adherence to our philosophies of:

- > Disciplined active management
- > Avoid style drift
- > Credit loss avoidance
- > Experienced risk management

Weak GDP growth and consensus expectations are affecting hiring intentions

Chart 3: US GDP is well below previous cycle averages, and consensus expectations are muted



Source: Macquarie, Thomson datastream



Portfolio Positioning

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.

Neutral in duration as technical and fundamental signals indicate low for longer in Treasury rates

The short to intermediate portion of the yield curve may continue to flatten, accelerating if QEII is implemented

Technical measures in the Treasury sector point to lower rates in intermediate maturities

We are underweight Agency MBS due to, in our view, high pre-payment risk

The Microsoft fractional coupon bond was indicative of the positive fundamental and technical signals in credit

We are neutral CMBS due to our investment process signaling heightened volatility and concerns towards fundamentals

Duration: *Neutral.* Our investment process advocate's a neutral duration to benchmark due to our fundamental and technical signals. These signals clearly illustrate to us the Federal Reserve is on hold for an extended period, economic growth and the momentum of this growth is weak (see charts 1 & 2), and technical analysis shows interest rates are firmly supported at their low rates.

Yield Curve: *Flattening of front to intermediate.* We have continued to position portfolios for a flattening of the front to intermediate portion of the yield curve as quantitative easing, accommodative monetary policy, and the Federal Reserve re-investing MBS paydowns in Treasuries leads us to view the flattening trend in the yield curve will continue. Our expectation is any flattening of the yield curve will be moderate, in comparison to the past few months.

Treasury and Agency: *Overweight Treasuries, underweight Agencies.* We are overweight Treasuries as a short term tactical position due to our outlook for interest rates coupled with our negative view on Agency MBS. Treasuries look to remain low in yield for the foreseeable future due to the fundamental and technical signals discussed above. In our view, Agencies have limited value at current spread levels and are at risk to any "October Surprise" and reform initiatives announced with the Government Sponsored Enterprises of Fannie Mae, Freddie Mac and Ginnie Mae.

Agency MBS: *Underweight.* Prepayment risk, high dollar prices, and the uncertainty towards fiscal policy and the elections leave us underweight Agency MBS. In our view, prepayment risk is high as monetary policy continues to drive mortgage rates to record lows. Additionally, with an election cycle of particular contention, we could see further policy that negatively impacts Agency MBS by accelerating pre-payment activity.

Corporate Bonds: *Overweight.* Corporate bonds, which have rode a bull market over the past two years of record returns, continue to remain attractive based on fundamental factors and very high demand from retail investors. Corporate fundamentals (debt to free cash flow, asset coverage ratios) have strengthened as corporations have de-levered and limited capital expenditures have left corporations with high cash balances and strong bottom-up attributes. Most recently, as evidence of demand for credit issues, Microsoft in September issued the first ever 'fractional' coupon bond, a 3-year bond at a coupon of 0.875%.

Structured Credit: *Underweight ABS, Neutral CMBS.* CMBS, which have been key driver of our performance in many strategies, have moved to fair value in our models and we are at a neutral weighting. While we see value in many CMBS structures where we use our credit intensive security selection process; heightened volatility, poor overall sector fundamentals and risk aversion leaves use neutral on CMBS.



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