Macquarie Allegiance

Fixed Income Commentary | August 2009

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Positive global data momentum continues

The run of positive global data surprises was unabated in August, with most indicators of activity surpassing expectations. This further reinforced the consensus view that the global recession ended sometime in the June quarter and that the global economy has now entered a recovery phase. Analysts generally expect the initial stages of the recovery to be characterised by a solid rebound in activity as firms lift production to prevent a further unwanted drawdown in inventory levels. The improvement continued in global surveys of industrial activity, including a marked lift in output and new orders. In the U.S. ISM survey to their highest levels in almost 5 years, has lent support to this view.

A sustained bottoming of housing indicators would be positive for the consumer

Also crucial to the recovery view are signs of stabilization in final demand. Consumer spending has increased in most economies in recent months, driven in large part by government incentives to replace ageing motor vehicles. In the U.S., the so called 'cash-for-clunkers' program produced a cumulative 45% jump in new auto sales in July and August, the period over which the scheme operated. Meanwhile the data increasingly points to a recovery in U.S. housing activity taking hold. The Government's $8,000 first-home buyer's tax credit along with the low interest rates and the earlier sharp fall in house prices have helped see total home sales rise by 18% from their January trough. This in turn has seen a reduction in the stock of homes for sale, especially new homes and has helped spur a rebound in commencements of single family homes. Arguably of most significance for the outlook, however, was the revelation that the S&P Case Shiller house price index recorded its first monthly gain in almost 3 years as 75% of cities recorded price gains in June. Given the role falling house prices played in the downturn, signs that house prices have bottomed, if sustained, would represent a big lift for the household sector.

Pace of job losses slowing

The improvement in activity has also translated into some much needed signs of improvement in global labor markets, with the pace of job losses slowing in many economies. The improvement has also been particularly noteworthy in the U.S. where the pace of payrolls losses continued to slow in August, especially when the impact of Chrysler and GM's emergence from bankruptcy is excluded. While the labor market is still quite weak, as seen in the sustained uptrend in the unemployment rate to a 26 year high of 9.7%, the slowing in the pace of job losses combined with some signs of improvement in hourly earnings has seen aggregate wages stabilize in the past two months. This represents a marked improvement from the significant decline in incomes seen in prior months which in turn may contribute to a relatively more positive near term outlook for consumer spending. To be sure, by no means do we believe the current environment is one where we would expect to see a strong gain in consumption. But equally it appears unlikely that we will see the return of the sharp declines in consumer spending seen in the latter part of 2008 and early 2009. This may in turn help support the rebound in production currently underway.

No news from Jackson Hole

Within the U.S., the news from the Jackson Hole symposium also lent credence to the view that policymakers will remain accommodative in policy. This year's conference, entitled Financial Stability and Stabilization, focused on debates in regards to asset bubbles and policy response to them. *The Greenspan doctrine of non-intervention was severely challenged*. Discussion towards exit strategies and inflation were limited and concern was given towards the potential for short term deflation triggered by this cycle's credit and housing bubbles.

Central Bankers have been quick to highlight the successful response to policy……

Policymakers have been quick to highlight their success and Ben Bernanke's re-appointment by President Obama was evidence of the growing confidence of policies and actions taken. Initially slow to respond in 2008, The Fed and Treasury's unprecedented action following the events of last September led to a reduction in systemic risk through liquidity facilities, guarantee programs and quantitative easing. In our March newsletter we said "Academic theory has become policy" as Bernanke instituted a deflation fighting roadmap he originally outlined in 2002. The Great Depression scenario envisioned in the first quarter has lead in the second half of 2009 to an outlook by many of a sharp and quick rebound in economic activity.

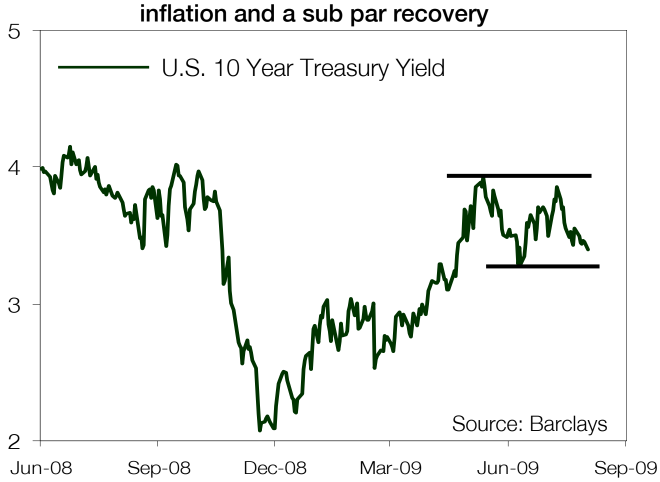
…..While quelling any concern towards a tightening of fiscal or monetary policy

Even with the short term triumphs, policymakers are still concerned with the sustainability of economic activity. The consumer outlook is difficult amid high unemployment. Thus policymakers have been quick to quell any concerns of a removal of stimulus or loose monetary policy. The lesson of 1938, in which monetary policy was defacto tightened through a contraction in the money supply and rising taxes (social security taxes were collected for the first time) has been highlighted by many policy officials as a reason today to keep policy accommodative for the foreseeable future.

Higher borrowing costs may derail any recovery

Twice this year, concerns over monetary policy and inflation have lead to the 10 year Treasury yield approaching 4%. Each time, policy makers have been successful in reducing long term inflationary concerns or exit strategies and yields have trended lower. *It is interesting to note that stock and bond prices have been rising in tandem over the past three months, ignoring a historical negative correlation*. This is conducive to our view that an economic recovery would be damaged by higher borrowing costs.

Treasury range to continue, amid lower trend inflation and a sub par recovery



As a leading indicator, unemployment needs a sustained improvement before first rate hike

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A prolonged period of deleveraging and sub-trend growth is upon us

The trend in data continues to be of a improving economy, although the consumer and employment outlook remain subpar. A delicate balancing act remains between policymakers goal of a sustained economic improvement and the need to keep borrowing rates low. Any misinterpreted signal or statement by policymakers could flare up concerns over short term rate hikes, flattening the yield curve significantly. This may be damaging to many industries, including financials. As we have stated over the course of the past year, we are recovering from deflationary events of housing and credit bubbles and we expect sustained low borrowing costs will be key to the recovery.

The Fed is on hold well into 2010

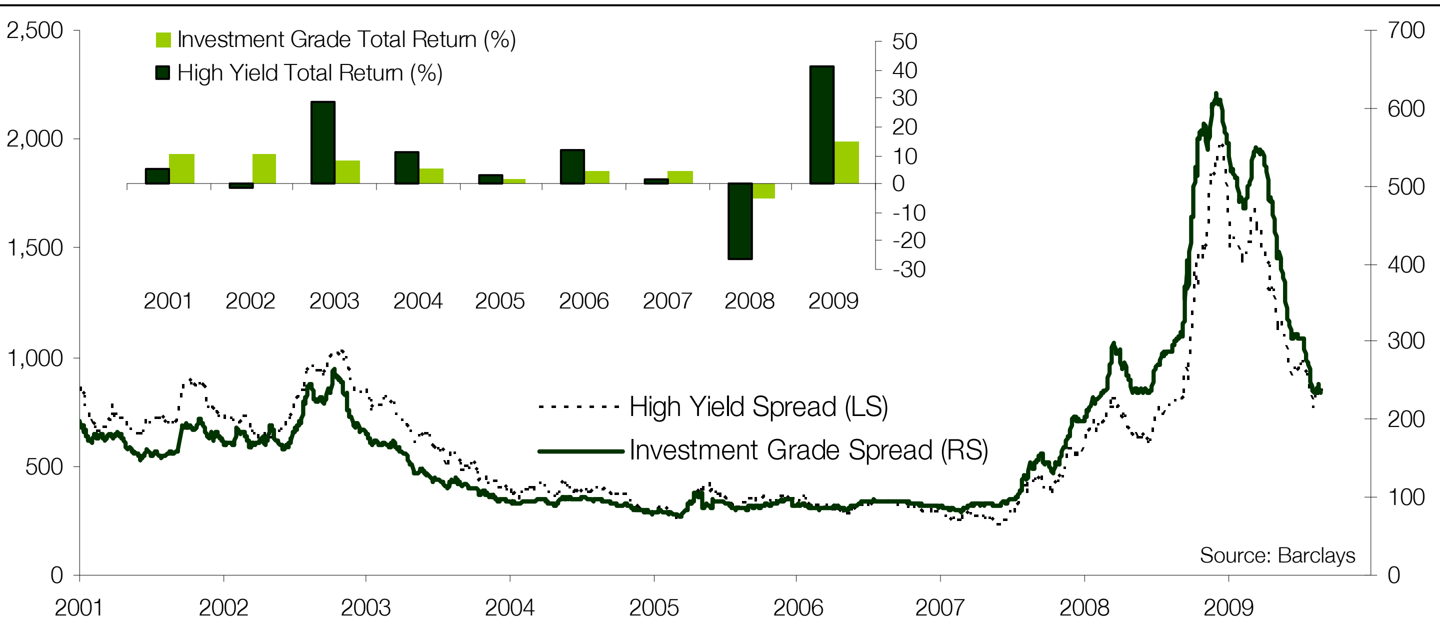
In Sum: The economy continues to show improvement, surprising to the upside. The pre-conditions for a tightening of monetary policy remain non-existent, but pressure will remain on policy makers to detail exit strategies and manage long term inflationary concerns from this cycles monetary policy. With our view of benign inflation and a subpar recovery, Treasury rates will remain range bound. We continue to view the Federal Reserve on hold well into 2010.

Portfolio Positioning and Strategy

Macquarie Allegiance manages separate accounts, invested in a variety of 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: *At benchmark*. Gradual improvement in data flow, issuance and the outlook for economic activity (Global PMI's have surprised to the upside) is putting an upward influence on Treasury yields. However, with inflation trending lower, the Fed on hold and our expectations the range bound environment will persist, we hold benchmark duration at month end.

2009: THE YEAR OF CREDIT



Curve flattening became the trend in August

Yield Curve: *Flattening.* We entered into flattening trades in the first week of August. Earlier this quarter, the yield curve reached record steepness (as measured by the 10 year minus 2 year yield) driven by inflationary angst and supply pressures. In August, curve flattening has been the trend, driven in part by lower inflation readings and policy maker's efforts to contain concerns towards an exit strategy. In addition, valuations in the short end of the yield curve currently advocate an overweight to intermediate maturity bonds.

The key level to watch continues to be 4% on the 10 Year Treasury

Treasury and Agency: *Underweight Treasuries, neutral/underweight Agencies*. As a trend following manager, we continue to reduce (increase) Treasury allocations as they approach the bottom (top) of the current trading range (3.3% to 4.0% on the 10-year Treasury). At month end the yield on the 10-year Treasury was 3.3%, warranting an underweight position. Treasuries look to remain range bound as economic activity gradually improves but inflationary measures trend lower. Until a break of technical levels (currently 4% for the 10-year) we will tactically increase and decrease our exposure through the range, seeking to capture capital gains.

High coupon Agency MBS outperformance expected to continue

Agency MBS: *Overweight*. Agency MBS performance continues to remain strong, driven by multiple factors. Higher yields, lower durations coupled with the Treasury purchase plans of up to $1.25 trillion have firmly put a floor under Agency MBS prices. Within our overweight across portfolios, we continue to focus on up-in-coupon (6 & 6.5%) seasoned Agency MBS which our analysis shows limited prepayment characteristics. Our overweight and security selection in Agency MBS have been a primary driver of returns in our AAA-only portfolios.

Corporate Bonds outperformance may continue as well

Corporate Bonds: *Overweight.* 2009 may be remembered as the "year of Credit" as Corporate Bonds are potentially on path to the greatest outperformance in the history of the indices. We have continued to gradually increase our exposure throughout the year, although the speed of spread compression has occurred quicker then we expected. Despite this, with the macroeconomic indicators continuing to surprise to the upside and policy makers seemingly happy to sit on the sidelines, credit markets remain in the "sweet spot" for outperformance. Thus, any signals from policy makers that they will move to tighten is viewed as a major threat to the credit rally. Until we see this our strategy is expected to remain overweight credit

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Economic Indicators	Current Aug-09	Prior Jul-09
ISM	48.9	44.8
Factory Orders	0.4%	1.1%
Unemployment Rate	9.4%	9.5%
Change in NFP	-247K	-443K
Producer Price Index (PPI) MoM	-0.9%	1.8%
Core* PPI MoM	-0.1%	0.5%
Consumer Price Index (CPI) MoM	0.0%	0.7%
Core* CPI MoM	0.1%	0.2%
CPI YoY	-2.1%	-1.4%
Core* CPI YoY	1.5%	1.7%
Retail Sales less Autos	-0.6%	0.5%
Industrial Production	0.5%	-0.4%
Capacity Utilization	68.5%	68.1%
UoM Confidence	65.7	66.0
Housing Starts	581K	587K
Leading Indicators	0.6%	0.8%
Consumer Confidence	54.1	47.4
S&P/Case-Shiller Comp-20 YoY	-15.4%	-17.0%
New Home Sales	433K	395K
Durable Goods Orders	4.9%	-1.3%
Chicago Purchasing Managers	50.0	43.4

*Less Food and Energy — Source: Bloomberg

Financial Indicators	Current Aug-09	Prior Jul-09
Oil	69.87	69.29
CRB	253.72	256.58
JOC	93.67	89.04
Yen to Dollar	92.99	94.79
Euro to Dollar	1.43	1.43
DX	78.16	78.45

Quarterly Economic Indicators	Current 2Q09	Prior 1Q09
GDP - Real QoQ	-1.0%	-6.4%
GDP - Real YoY	-3.9%	-2.5%
GDP - Nominal QoQ	-1.0%	-2.9%
GDP - Nominal YoY	-2.4%	-0.4%
Non-Farm Prod QoQ	6.4%	0.3%

On the Run Treasury Yields	Current Aug-09	Prior Jul-09
Fed Target Rate	0.25%	0.25%
2-year	0.97%	1.12%
5-year	2.38%	2.53%
10-year	3.40%	3.50%
30-year	4.17%	4.31%

Barclay's Index Information	Duration	Monthly Return	YTD
Aggregate	4.35	1.04	4.62
Government	4.75	0.79	-1.94
Intermediate Aggregate	3.48	0.92	4.97
Intermediate Government	3.63	0.63	-0.46
1-3 Year Gov't	1.87	0.38	1.05
U.S. MBS	2.92	0.67	4.45
Corporate	6.37	1.83	15.06
High Yield Bonds	4.34	1.86	40.95
Emerging Market	6.22	2.93	25.39

Source: Barclays

Sector Excess Returns	Month	YTD
Agency	-0.04	2.29
Corporate	0.76	18.41
CMBS	1.74	23.06
ABS	1.80	21.15
MBS	0.19	3.75

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