Macquarie Allegiance

Fixed Income Commentary | July 2009

Continued improvement in data flow led risk assets higher

The global economic data flow once again surprised to the high side of expectations in July. This lent weight to the consensus view that the global economy is entering a recovery phase and prompted a further upward revision to analysts forecasts for growth in the second half of the year. This followed the release of GDP data for the U.S. which showed the economy contracting at a more moderate pace in the June quarter than at the start of the year. As in prior months, the strengthening in global activity has been most evident in business survey measures of manufacturing activity. Having fallen to multi-decade lows in the months following the collapse of Lehman Brothers as firms aggressively cut output, most measures of industrial activity have recovered to levels consistent with a modest expansion in production. In addition, the past month has shown clear signs of a pick-up in U.S. housing activity, led by a rebound in home sales. This in turn has seen a sharp fall in the stock of homes for sale and a slowing in the pace of decline in house prices, an important development following three years of significant declines in house prices and wealth.

Asian economies have led in this recovery, driven by record stimulus

Emerging economies in Asia have also shown further improvement across a range of indicators. This is especially notable in China, driven by Government stimulus which has significantly boosted fixed asset investment. GDP growth subsequently surprised well to the high side of expectations in the June quarter, prompting analysts to revise upward their forecasts for annual growth in 2009. If anything we believe that analysts are still underestimating the extent to which Chinese activity has recovered in recent months, with most indicators still being weighed down by the weakness in activity in the second half of 2008. Our analysis indicates that industrial production in the first six months of 2009 is growing at an annualized rate of almost 20%, well above its long run average rate.

Unemployment better, but not good

Reflecting the signs of recovery in industrial activity, recent weeks have seen signs of improvement emerge in global labor markets. This is most notable in the U.S. where the pace of payroll declines slowed significantly in July from that seen over the first half of the year while the unemployment rate surprisingly fell slightly to a still elevated 9.4%. While the rate of change is improvement in the labor market appears underway, we believe that the latest data overstates the extent of improvement that has occurred. This reflects a distortion caused by the earlier bankruptcy of GM and Chrysler to the normal seasonal pattern of maintenance-related plant shutdowns in the auto sector in July which saw employment rise in the sector for only the third time in the last three years.

We are concerned towards outlook for the consumer

Not all the data has been positive, however, with cracks emerging on the consumer front in the US as the impact of earlier fiscal stimulus on incomes begins to fade. With nominal disposable income recording its first annual decline since WWII, the trend for consumption has turned negative, although Government incentives encouraging consumers to scrap aging motor vehicles saw a surge in new car sales in July. Looking ahead, we remain concerned that despite the underlying improvement in the labor market, the pace of employment losses will remain too large to allow consumers to maintain spending against the back drop of continued balance sheet repair. Should consumer spending decline over coming months, then the recent increase in industrial activity and pull forward of demand (cash for clunkers) could be short lived and growth would disappoint market expectations.

Inflationary indicators remain firmly in deflationary territory

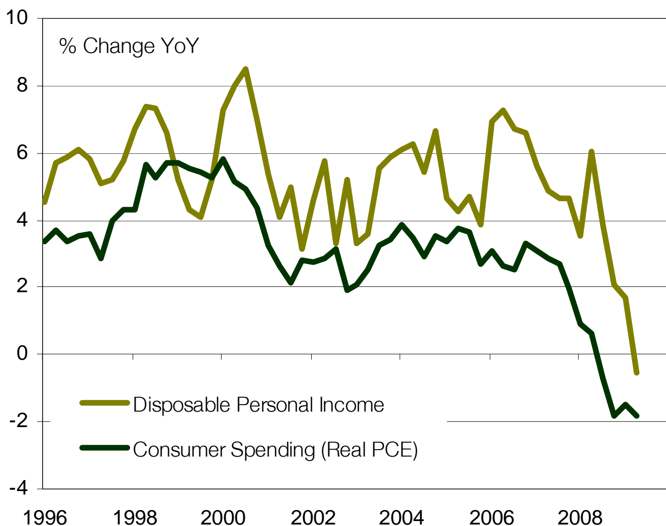
Turning to the U.S., data momentum remained strong in July, despite high unemployment and weak consumer spending. Of note has been the marked improvement in analysts expectations for earnings and economic data. This led to a strong rebound in credit spreads, equity markets and expectations for Federal Reserve rate hikes. We believe the fixed income markets are prematurely pricing in rate hikes this year as our base case scenario continues to see weak growth and a sub par recovery. Monetary policy does not work in a vacuum and is subject to the market forces of improving data flow and inflationary concerns towards this cycle's monetary policy. However, as the recent data has shown, inflationary indicators are still firmly in deflationary territory (employment, capacity utilization, output gap, wage growth, unit labor costs, housing). Furthermore, the Federal Reserve in speeches and press statements share our concerns towards this bounce in economic activity being sustainable.

Central banks need to keep borrowing costs low to sustain a recovery

In a balance sheet and deleveraging recession, improving indicators and sentiment can easily be curtailed by higher private cost of capital for consumers and businesses. A material rise in yields would likely derail a recovery, and monetary policy officials are aware of that. The key will be the Federal Reserve's ability to manage expectations of an exit strategy and keep yields down, in particular towards the intermediate to long end of the curve. This is a difficult task due to already poor valuations on many fixed income sectors and record Treasury issuance on a near weekly basis. With our view of a weak recovery and that deflationary pressures will persist, the Federal Reserve will manage to keep yields range bound, in particular if the Federal Stimulus efforts to pull forward consumer demand fades in the second half of this year with disappointing economic data.

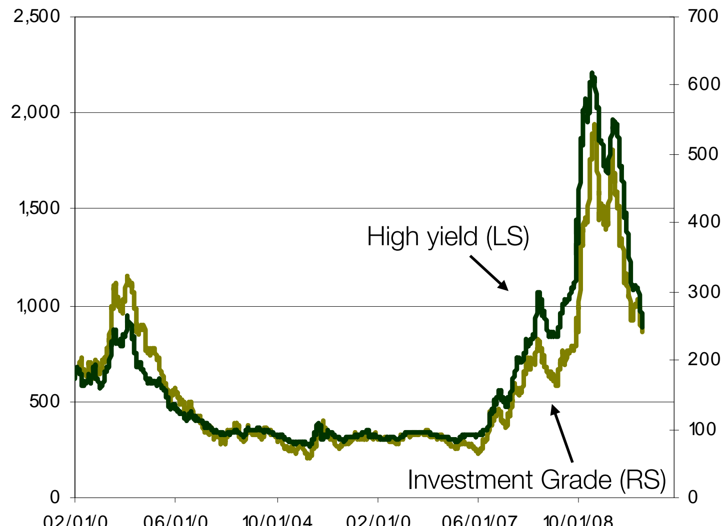
In Sum: The Federal Reserve is on hold for the near future, potentially through 2010, in a period of weak growth, high unemployment and deflationary pressures. Any pricing of rate hikes this year or next may prove to be premature.

Consumer Spending will be driven by wages and income. A weak spending outlook is our base scenario.



Source: Federal Reserve

Corporate Bond Spreads have returned to pre-Lehman levels



Source: Barclays

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.

The Fed is on hold and rates are range bound

Duration: *At benchmark*. Improving economic data flow and the outlook for economic activity (LEI for instance) is putting an upward influence on Treasury yields. However, with a view of an on hold Fed, range bound treasuries and a weak recovery, we hold a benchmark duration at month end.

Yield Curve: *Neutral.* The yield curve flattened in July as markets priced in rate hikes. Entering 2009 we were strongly of the opinion the curve was going to steepen and our clients benefited from this positioning. Since June we have remained neutral in our curve trading decisions. With the Fed on hold, short term rates should remain capped until a stronger economic recovery is evident. This leaves us neutral until further evidence of either a recovery or continued weakness drives our curve decisions.

The Treasury trading range will persist until clearer evidence on the economy's direction

Treasury and Agency: *Slight underweight in Treasuries, overweight Agencies*. Treasuries look to remain range bound as economic activity gradually improves and inflationary measures trend lower. The accelerating supply calendar will continue to put an upward bias on rates, but with weakness in the recovery expected and Fed rhetoric to keep rates low this should keep rates contained. The issuance is leading to us reducing our Treasury weighting into weeks of high issuance, as the auctions are driving yield movements in the current range. This range has been supportive of our tactical active management as we are increasing exposure to Treasuries as they approach the top of the range and fade exposure as they move towards the bottom. The key level to watch continues to be 4% for the 10-year Treasury and any move higher would be bearish for interest rates in the intermediate to long end of the maturity spectrum.

Agency MBS continue to drive our performance in the AAA-only portfolios

Agency MBS: *Overweight*. Agency MBS strong performance this year, up 3.76% vs -3.90% for Treasuries (source: Barclays) has been 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, seasoned Agency MBS which in our analysis, have limited prepayment characteristics. Our overweight and security selection have been a primary driver of our returns in our AAA-only portfolios.

Corporate outperformance may continue, however at much less excess return than the past four months

Corporate Bonds: *Overweight.* Corporate bonds continued their outperformance in July amid improving data flow, business indicators, earnings and expectations for defaults. We have gradually increased our exposure throughout the year, bringing our long held underweight to neutral in the 2nd Quarter. The process of accumulation of corporate credit continued through July, with particular focus on name selection and liquidity. Despite the rally, valuations of corporate credit remain historically cheap. While the economy is showing increasing signs of recovery, spreads have rallied ahead of that news. We therefore prefer to accumulate in periods of corrective spread widening. The default cycle, earnings and at what rate the economy recovers will drive valuation going forward.

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Economic Indicators	Current Jul-09	Prior Jun-09
ISM	44.8	42.8
Factory Orders	1.2%	0.5%
Unemployment Rate	9.5%	9.4%
Change in NFP	-467K	-322K
Producer Price Index (PPI) MoM	1.8%	0.2%
Core* PPI MoM	0.5%	-0.1%
Consumer Price Index (CPI) MoM	0.7%	0.1%
CPI YoY	-1.4%	-1.3%
Core* CPI YoY	1.7%	1.8%
Retail Sales less Autos	0.3%	0.4%
Industrial Production	-0.4%	-1.2%
Capacity Utilization	68.0%	68.2%
UoM Confidence	66.0	70.8
Housing Starts	582K	562K
Leading Indicators	0.7%	1.3%
Consumer Confidence	46.6	49.3
S&P/Case-Shiller Comp-20 YoY	-17.1%	-18.1%
New Home Sales	384K	346K
Durable Goods Orders	-2.5%	1.3%
Chicago Purchasing Managers	43.4	39.9

*Less Food and Energy

Source: Bloomberg

Barclay's Index Information	Duration	July	YTD
Aggregate	4.31	1.61	3.54
Government	4.68	0.48	-2.71
Intermediate Aggregate	3.46	1.37	4.01
1-3 Year Govt	1.86	0.21	0.67
U.S. MBS	2.89	0.82	3.76
Corporate	6.34	4.32	12.99
High Yield	4.31	6.09	38.37
Emerging Market	6.19	3.46	21.81

Source: Barclays

Financial Indicators	Current Jul-09	Prior Jun-09
Oil	69.29	69.84
CRB	256.58	250.78
JOC	89.04	84.19
Yen to Dollar	94.79	96.35
Euro to Dollar	1.43	1.40

Quarterly Economic Indicators	Current** 2Q09	Prior 1Q09
GDP - Real QoQ	-1.0%	-6.4%
GDP - Real YoY	-3.9%	-2.5%
GDP - Nominal QoQ	-0.8%	-2.9%
GDP - Nominal YoY	-2.4%	-0.4%
Non-Farm Prod QoQ		1.6%

U.S. Treasury Yields	Current Jul-09	Prior Jun-09
Fed Target Rate		0.25%
2-year	1.12%	1.11%
5-year	2.53%	2.55%
10-year	3.50%	3.51%
30-year	4.31%	4.30%

** Most recent number available, may be subject to change.

Source: Bloomberg

Sector Excess Returns	July	YTD
Agency	0.42	2.32
Corporate	3.84	17.37
CMBS	7.22	20.84
ABS	1.63	18.92
MBS	0.54	3.54

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