



### Second quarter review and outlook

*We have seen indicators of economic bottoming and financial meltdown appears to have been averted*

The second quarter saw material improvements in expectations, confidence and the market's outlook for future economic activity. Improving economic indicators and the hopes of 'Green Shoots' however, are in sharp contrast to a weaker than expected June employment report. The U.S. economy is transitioning from the sudden stop in economic activity in the last few quarters to a cyclical improvement but with a continued weak outlook. Over the next two quarters, we see fits and starts of economic activity with no clear trend as the consumer de-levers and balance sheets are repaired. The Federal Reserve is on hold well into 2010 and with weak economic data leading to fewer upside surprises, Treasury yields may have peaked in mid-June for the year. **Our view remains that an extended, multi-year de-leveraging is at hand, leading to negative GDP growth for 2009.**

### THE ECONOMICS

*An improvement in indicators and data flow since the 1<sup>st</sup> Quarter*

June continued the general improvement seen in economic indicators for the quarter, albeit the unemployment report highlighted an extremely weak outlook for the consumer. Many leading indicators have now solidly bounced off their 1st quarter troughs and the Leading Economic Indicator (LEI) rose in April and May. Much of this improvement is undoubtedly due to the Federal Governments support programs injecting the markets with much needed liquidity to the point where most market participants now view the risk of systemic meltdown of the financial system as remote. So while we are seeing improvement, the bar was not set particularly high and the real key to the recovery will be consistency of these indicators over several periods.

*The consumer continues to be faced with a difficult outlook*

#### **If there are signs of economic recovery, it is not with the consumer**

The June employment report, released in the first week in July by the Bureau of Labor Statistics, put a further hit to market hopes for a quick recovery. The details of the report were quite negative with average hours worked falling and flat hourly earnings (deflationary). In last month's commentary, we highlighted the fact that rising mortgage rates, oil prices, and unemployment did not reconcile with a second half recovery. With unemployment rising and discretionary income being sapped by higher oil price's and mortgage rates, consumer spending will be an impediment towards growth. This began to show through in late June as indicators such as consumer confidence, mortgage applications and unemployment disappointed. ***An understanding of the consumer, in our view, is key to taking a macro position on U.S. economics. Currently, the outlook for the consumer appears mediocre at best.***

# Macquarie Allegiance

## Fixed Income Commentary | June 2009



*The Federal Reserve is on hold through the year*

### Why we believe the Federal Reserve will not raise interest rates this year

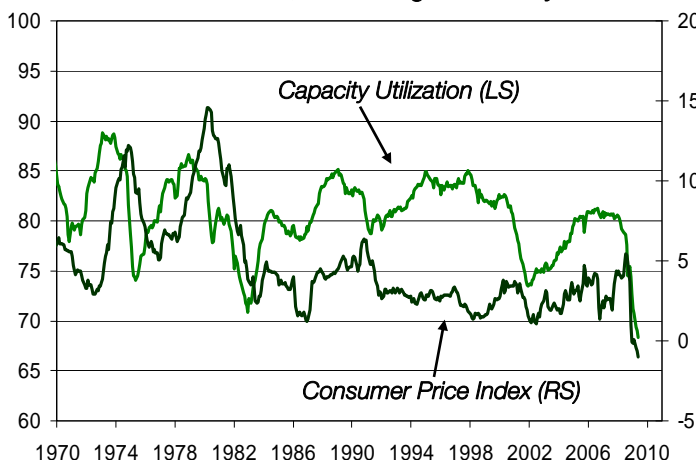
With an improvement in economic and market expectations in the second quarter, investors have begun pricing in rate hikes by year end. **We believe this to be highly unlikely and do not see the Federal Reserve raising interest rates until well into 2010.** We are in a structurally deflationary recession, one that gives the economic slack and spare capacity for the Federal Reserve to engage in quantitative easing, without raising interest rates.

### Our assessment of why the Federal Reserve will not raise interest rates:

*We are in a structurally deflationary environment*

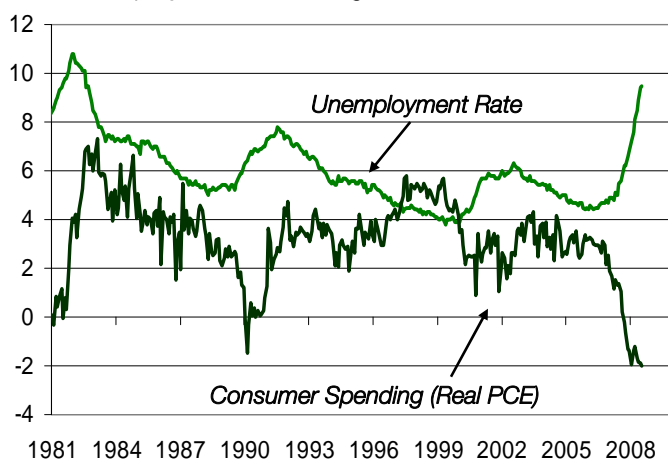
- > Potential economic output, as measured by the output gap and capacity utilization is at record lows.
- > We believe the unemployment rate will surpass 10% and will remain elevated into any economic recovery. There is a potential wage growth could turn negative, which is unprecedented.
- > Inflationary measures for broad based goods such as CPI and PCE deflator are turning negative, not seen since the 1950's.
- > Commodity prices are not inflationary in the U.S., they reduce spending
- > Economic and regulatory agencies, such as the OECD and CBO have recently revised down long term potential growth rates for the G-7 countries.
- > History has showed us financial crisis and housing busts are inherently deflationary as consumers retrench, rebuild savings and private credit and household net worth contract.
- > The Federal Reserve is acutely aware of the risks of removing monetary and fiscal stimulus too early.

*Output gaps and excess capacity may keep the Fed on the sidelines, not raising rates this year*



Source: St Louis Federal Reserve for both charts

*Consumer spending may be weak amidst high unemployment and falling income's*



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## Fixed Income Commentary | June 2009



***Concern towards the medium term view and a sustained recovery***

In a guest article in the June 18th edition of *The Economist*, Christine Romer, Chairwoman of the President's Economic Council, highlighted the concerns towards removing stimulus too quickly. Dr. Romer discussed the tightening of monetary policy in 1937 in which monetary policy in an environment of improving economic growth, was made less accommodative. This tightening of monetary policy too early in the business cycle led to a double dip recession. Ben Bernanke, like Dr. Romer, is well versed in economic history, and well aware that the 2<sup>nd</sup> Quarter improvement in economic data and capital market expectations is fragile, being supported by Government intervention and stimulus. ***To remove these efforts too quickly or to curtail current programs could lead to a second recessionary episode.***

***Inflation will continue to be a hot topic, but is likely not to materialize this year***

Inflationary concerns have resurfaced as economic contraction is finding a bottom and the cyclical monetary policies worry investors. The implications of fiscal deficits, money supply and quantitative easing have led to inflationary expectations rising. The future for deficits and its potential impact on economic growth, coupled with a demographic problem of future unpaid entitlement programs at the State and Federal level is concerning. Additionally the implications of the loss of manufacturing capacity, production and employment should a sustained increase in economic activity accelerate could close output gaps and stoke inflation.

However, we are in a period in which policy makers will do whatever it takes to prevent deflation and we believe this will drive monetary and fiscal policy. A deflationary spiral of falling demand, falling prices, defaults, bankruptcies, and wage cuts can be difficult to break, as evidenced by Japan and its lost decades. ***Policymakers will do all they believe is necessary today to push the economy back into positive growth, at the potential for longer term problems in the future.***

***An extended period of deleveraging will continue into 2010***

In sum, the second quarter saw a dramatic reduction in risk premium as the government intervention and programs took hold. The capital markets have repriced expectations to a recession, not depression. We remain cautious on economic growth and do not view that conditions are in place for a quick and sustained turnaround. We believe, the second half of 2009 could prove a frustrating one for market participants as the economy sputters in fits and starts, as consumer retrench and de-lever. Inflation, while always being a long term phenomenon will not materialize this year as the excess capacity and deflationary environment keep the Fed on the sidelines through at least mid 2010.

There is a traditional caveat in all marketing materials that past performance is not indicative of future results. ***Over the past thirty years, recessions have been relatively mild, as ample monetary and fiscal stimulus coupled with factors such as technological innovation and rising productivity prevented sharp downturns.*** We are clearly in a period in which the data of the past must be looked at cautiously in evaluating the future. We will look to the data flow to drive our positioning, ever cognizant that the past thirty years of capital market expectations, returns and economics may not be indicative of the next thirty.



### THE CAPITAL MARKETS

***We believe Treasury yields peaked in mid-June for 2009***

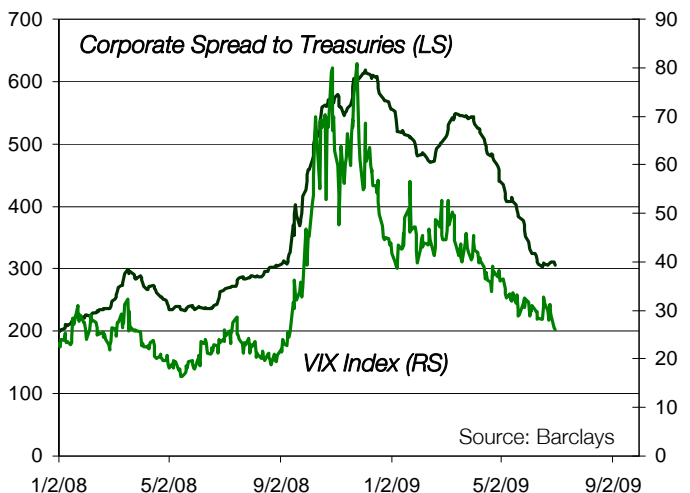
For June and for the quarter, fixed income sector performance was in line with the improving economic data. U.S. Treasuries rose in yield as data improved, risk aversion abated, supply accelerated, and investors took more portfolio risk. U.S. Treasuries underperformed relative to all other sectors, with a total return of -3.02%. Treasuries will continue to be influenced on one hand with the inflationary forces of cyclical monetary policy and on the other by the deflationary forces of this recession. This leaves us with the view Treasuries will remain choppy in terms of their direction upon each data point released. ***With our outlook of weak economic data and benign inflation in the second half of 2009, we believe Treasury yields may have peaked in Mid-June for 2009 as the 10-Year Treasury briefly approached 4%.***

***Corporate bonds outperformed amid improving data flow and valuations***

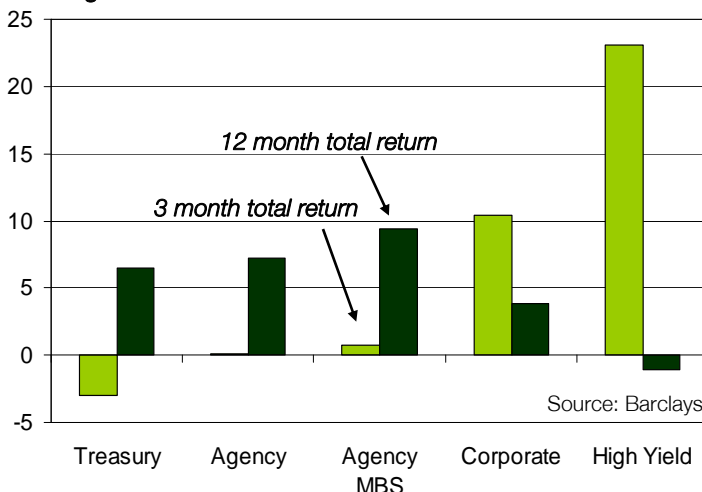
Corporate bonds, coming off the worst two consecutive quarters of performance in the sector's history (4Q08 and 1Q09, Source: Barclays), outperformed as the sector saw inflows from retail and institutional investors and risk premiums, as measured by the Volatility Index (VIX) fell. In addition the improvement in Industrial Production and earning reports gave further support the sector was attractively priced.

For the quarter, Corporate Bonds and High Yield returned 10.45% and 23.07% respectively, the highest quarterly total returns since the inception of the indices, going back to 1983. Going forward, while valuations on many corporate securities remain attractive, the tremendous run-up in prices in the 2nd Quarter has led the sector, in our view to be more fairly valued, in particular for a prolonged recession and default cycle. In 2Q09, Moody's speculative default rate was 10.2%, up from 7.6% in the 1Q09. We continue to gradually increase our slight overweight in the portfolios that employ corporate bonds. We focus our positions in financials, healthcare, industrials and select Sovereign bonds.

***A reduction in risk premium and improving data flow.....***



***.....Led to record setting returns for Corporate and High Yield bonds in the 2<sup>nd</sup> Quarter***



# Macquarie Allegiance

## Fixed Income Commentary | June 2009



*We continue to favor overweight's in Agency MBS*

In the 2<sup>nd</sup> Quarter, Agency and Agency MBS securities out-performed relative to Treasuries in the Government sectors (Source: Barclays). In particular Agency MBS continue to be supported by market demand and the government programs to reduce private sector mortgage rates. For the year, the Barclays MBS Index returned 2.91%. While concerns remain over the future of the Government Sponsored Enterprises (GSE) of Fannie Mae and Freddie Mac, the debt of the GSE is being supported by the U.S. Treasury, albeit stopping short of a full Government guarantee.

To date, the U.S. Treasury has provided \$200b each to Fannie Mae and Freddie Mac to maintain positive net worth and provided liquidity facilities. In addition, the NY Federal Reserve has begun a debt purchase program of more than \$1.25 trillion in an effort to reduce private sector mortgage rates and reduce the borrowing costs for the GSE. The size of these plans and comments by government officials in support continue to leave market participants of the view that the guarantees are more than just "implied". ***In Agency MBS we favor the sector and hold overweight's relative to our index targets for all portfolios. We favor seasoned, up in coupon MBS, with limited refinancing characteristics.***

### PORTFOLIO COMMENTARY

*We are neutrally positioned entering the 3<sup>rd</sup> Quarter.*

Throughout the quarter, we maintained a defensive oriented investment allocation. Our positioning was driven by our Investment Committee view that improving economics and data flow would lead interest rates higher. For the quarter, our portfolio's benefited from (i) sector rotation, and (ii) yield curve and duration positioning as interest rates rose and the yield curve steepened. ***For our AAA-only portfolios, the strategies zero exposure to corporate bonds, per the mandate, led to the underperformance relative to the Aggregate Indices.***

Entering the third quarter, with our view of a prolonged recession and disappointing economic activity, we have moved to a neutral positioning in terms of duration and yield curve. This is in contrast to the defensive positioning of the 2<sup>nd</sup> Quarter. We will look to the economic data flow to drive our investment themes going forward.

#### Key investment themes entering the 3<sup>rd</sup> Quarter:

*2<sup>nd</sup> Quarter performance was positively impacted by duration and yield curve positioning*

- > Moved to a neutral weighting in Treasuries from underweight, maintain overweight in Agencies
- > Portfolio durations are at benchmark, from below benchmark in the 2<sup>nd</sup> quarter
- > Reduced the yield curve steepening position to one that is more neutral
- > Increased our overweight to Agency MBS, focusing on seasoned securities
- > For our investment grade strategies we have moved to a slight overweight from neutral. We continue to gradually increase our overweight in corporate bonds.

# Macquarie Allegiance

Economic and Market Information



Economic Indicators	Current Jun-09	Prior May-09
ISM	42.8	40.1
ISM prices paid	43.5	32.0
Factory Orders	0.7%	-1.9%
Unemployment Rate	9.4%	8.9%
Change in NFP	-345K	-504K
Trade Balance	-\$29.2B	-\$28.5B
Producer Price Index (PPI) MoM	0.2%	0.3%
Core* PPI MoM	-0.1%	0.1%
Consumer Price Index (CPI) MoM	0.1%	0.0%
Core* CPI MoM	0.1%	0.3%
CPI YoY	-1.3%	-0.7%
Core* CPI YoY	1.8%	1.9%
Retail Sales less Autos	0.5%	-0.2%
Industrial Production	-1.1%	-0.7%
Capacity Utilization	68.3%	69.0%
UoM Confidence	70.8	68.7
Housing Starts	532K	454K
Leading Indicators	1.2%	1.1%
Consumer Confidence	49.3	54.8
S&P/Case-Shiller Comp-20 YoY	-18.1%	-18.7%
New Home Sales	342K	344K
Durable Goods Orders	1.8%	1.8%
Chicago Purchasing Managers	39.9	34.9

\*Less Food and Energy

Source: Bloomberg

Financial Indicators	Current Jun-09	Prior May-09
Oil	69.84	66.21
CRB	250.78	251.87
JOC	84.19	78.61
Yen to Dollar	96.35	95.14
Euro to Dollar	1.4043	1.4133
DX	80.47	79.45

Quarterly Economic Indicators	Current** 1Q09	Prior 4Q08
GDP - Real QoQ	-5.5%	-6.3%
GDP - Real YoY	-2.5%	-0.8%
GDP - Nominal QoQ	-2.9%	-5.8%
GDP - Nominal YoY	-0.4%	1.2%
Non-Farm Prod QoQ	1.6%	-0.6%

On the Run Treasury Yields	Current Jun-09	Prior May-09
Fed Target Rate	0.25%	0.25%
2-year	1.11%	0.92%
5-year	2.55%	2.34%
10-year	3.51%	3.47%
30-year	4.30%	4.33%

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

Source: Bloomberg

Barclay's Index Information	Duration	Monthly Return	YTD
Aggregate	4.30	0.57	1.90
Govt/Credit	5.21	0.86	0.55
Government	4.70	-0.13	-3.17
Intermediate Aggregate	3.48	0.33	2.60
Intermediate Govt/Credit	3.87	0.47	1.62
Intermediate Government	3.60	-0.27	-1.52
1-3 Year Govt	1.87	-0.14	0.47
U.S. MBS	2.95	0.12	2.91
Corporate	6.18	2.73	8.32
Majors Govts (ex U.S.)	6.73	0.21	-1.02
High Yield Bonds	4.34	2.86	30.43
Emerging Market	6.11	1.82	17.74

Source: Barclays, Data as of 06/30/09

Sector Excess Returns	Current Month	YTD
Agency	0.36	1.90
Corporate	2.83	13.14
CMBS	0.90	12.81
ABS	0.97	16.99
MBS	0.15	2.97

Swap Spreads	Jun-09	May-09
2-yr	42	40
5-yr	41	43
10-yr	24	19
30-yr	-14	-32

Source: Bloomberg

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