



First quarter review and outlook

Academic theory has become policy

Global economic contraction continued to push monetary and fiscal policies into uncharted territory. What had been academic theory in the halls of Princeton became policy as central bankers' worldwide attempt to offset the significant deflationary forces of recession and balance sheet deleveraging with reflationary policies. Non-monetary policy measures were implemented at a rapid clip: increased Agency and Agency MBS purchase programs, fiscal stimulus, increases in existing programs, direct purchases of U.S. Treasury debt and public/private investment programs to remove illiquid assets from bank balance sheets. Within economics, signs of stabilization are being seen in many indicators, but care must be taken in an interpretation of a sustained recovery. The past two years of false dawns and historical interpretations of data have led to failures in forecasting a turnaround this cycle.

Deflation fighting checklist continues

Bernanke moves further down the roadmap

Last November, we discussed what possible options were available to the Fed if a zero bound were reached in monetary policy. We used as our proxy a now famous speech given by Ben Bernanke, then a Federal Reserve Governor in 2002, entitled "Preventing Deflation: Making sure it doesn't happen here" (see our [November](#) or [January](#) commentary). This speech provided a roadmap to monetary policy actions designed to stimulate growth in a deflationary or zero interest rate environment. Over the course of the past two years, the Federal Reserve has followed this guide closely, providing market participants a roadmap to what policy measures could be implemented.

'Credit easing' becomes quantitative

On March 14th the Federal Reserve announced a plan to begin targeting U.S. Treasury rates in an effort to lower private sector borrowing rates. This was an important and significant event, in what can succinctly be called the last of the Fed's big non-monetary options. *What was described as 'credit easing' has become full blown quantitative easing.* We have discussed at length in previous commentaries that it was not the Fed Funds rate that mattered, but the private cost of capital. In normal business and interest rate cycles, nominal interest rates on Corporate bonds, mortgage rates, C&I loans, etc fall as the economy weakens and demand for credit weakens. In this cycle, private sector interest rates remained elevated and rose even as the Fed drastically lowered interest rates. Multiple plans have been implemented to lower rates, each with varying effect. This plan, along with the TARP/TALF programs, will be a significant step in lowering private sector interest rates.

The Fed stands ready to do all that is necessary, the response from the market "Be Bold"

Here's to 1954 and the significance of Fed action

The direct targeting of intermediate term Treasury yields is an extraordinary measure and in part continues to push the mantra of not fighting the Fed. It is also profound in what it says about Fed growth and inflation forecasts for the near term. It is not a coincidence that this extraordinary measure was last implemented in 1954, the last time that broad measures of inflation (CPI-U) were negative. The deflationary aspects of this crisis (rising unemployment, excess capacity utilization, rising output gap, rising real cost of debt) continue to worry policy makers and will continue to dominate monetary policy over the next year or possibly years. The answer clearly from the Fed is that they stand ready and willing to take any necessary steps to prevent deflation. With this action, we view the current policy actions and programs as being towards the last. It is more a question today of how large these programs grow, rather than what programs are yet to be implemented.

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All will be done today, at the potential cost of the long term

The potential long run implications of today's monetary and fiscal policy sending deficits to post war highs are disturbing. In addition, the implications of the serious loss of manufacturing capacity, production and employment should economic activity accelerate and the banking system improve in the next few years 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 this will drive monetary and fiscal policy in 2009 and likely 2010. Until financial intermediation returns and economic growth stabilizes policymakers will continue to do what is necessary today, at the potential risk of causing serious longer term problems in the future.

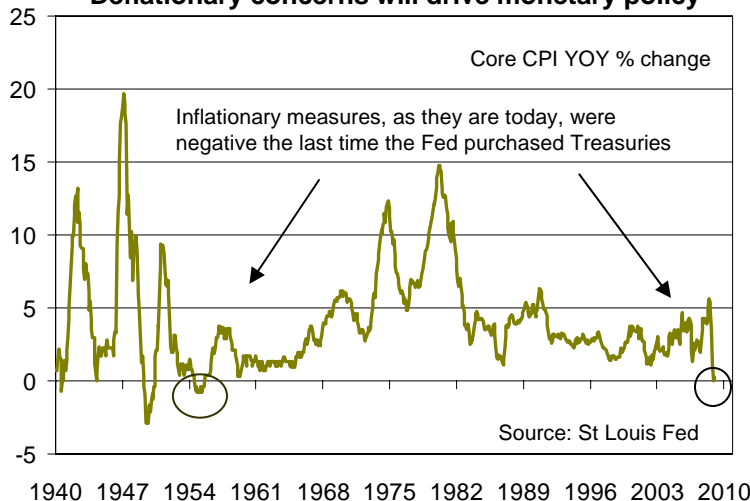
The long awaited program to remove illiquid assets was announced

In addition to the policy actions taken by the Fed, the U.S. Treasury announced the long awaited plan to remove illiquid assets from bank balance sheets. Secretary Tim Geithner brought forward the Public-Private Investment Plan (PPIP). This plan was enough to rally risk assets, but the plan continues to fall short of many of the details including: willingness of banks to sell assets below accounting values, political implications of using taxpayer financed leverage, recruiting enough private participants and how much of the illiquid assets will be sold off of balance sheets (current estimates of \$500 billion to \$1 trillion). Much remains to be answered but the Treasury is moving in the right step to get the securities market functioning again after significant false starts. **Economic history is factual and succinct, post banking crisis have shown rapid and quick government action to clean up institutions leads to quicker economic recovery and to less total damage of public finances in the long term. Perhaps this plan is only the starting point.**

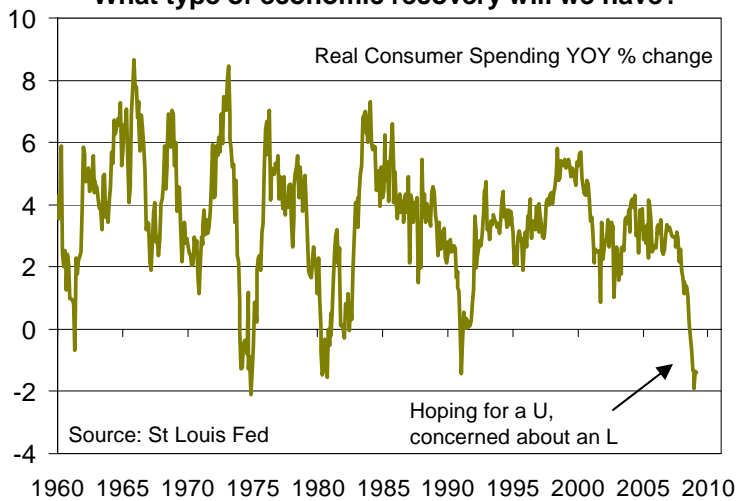
Leading indicators turned up in March, but this cycle has shown false dawns before

The Fed and Treasury's efforts and initiatives in the first quarter and in particular March, led to renewed risk taking to close the period. Going forward, with many economic indicators showing signs of stabilization, we may have passed the peak of negative annual change. While this is encouraging, this cycle continues to remind market participants that past performance is not indicative of future results. Unemployment continues to deteriorate, manufacturing indicators are in severe contraction, the banking system remains impaired, and the epicenter of this cycle, housing, continues to show declines. **An extended period of deleveraging and subtrend economic growth is base case scenario.**

Deflationary concerns will drive monetary policy



What type of economic recovery will we have?



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We continue to advocate caution, a long period of deleveraging is upon us

Central banks globally provided significant reinforcement by making bold plans and initiatives, but economics and rising geo-political uncertainty could prove to make the latest bout of risk taking short lived. We have frequently reinforced, in both our commentaries and portfolio positioning, that the past thirty years will not be representative of the next thirty. ***We remain cautious, continue to favor the fixed income sectors that are under the umbrella of Government support, and recognize that this cycle continues to have no precedent.***

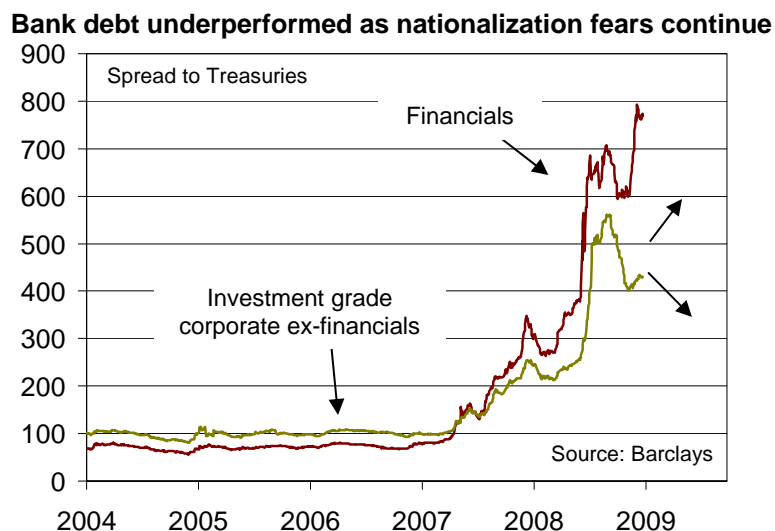
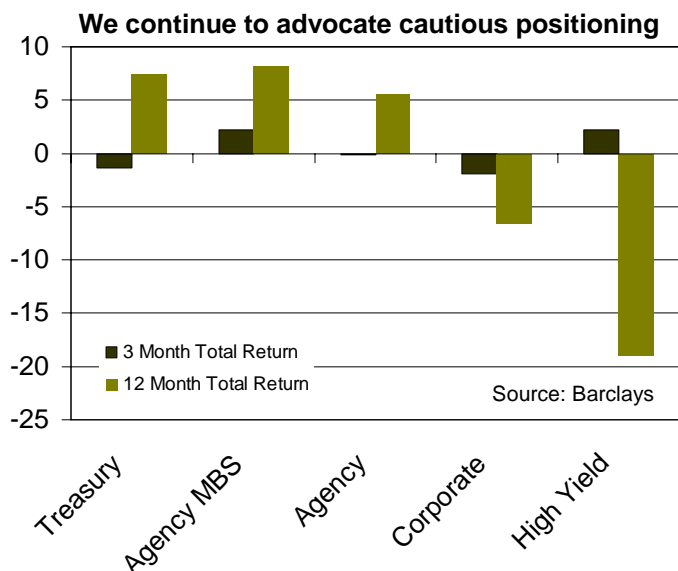
Market Commentary

Agency MBS, as a focal point for monetary policy continue to outperform

For the quarter, ***Agency and Agency MBS outperformed all sectors*** as they continued to be the focal point of reducing private sector borrowing costs by policy makers. Agency MBS have produced strong gains and have outperformed all sectors over the past twelve months (see chart below). In March the Fed and Treasury continued their growing support of the GSE (Fannie Mae, Freddie Mac) by increasing total purchase plans to more than \$1.25 trillion. Policy makers are increasing their support to these institutions because 1) the need to lower private cost of capital and 2) dependence for mortgage market securitization, which has ceased outside of the GSE. Investing in today's Agency MBS market in a period of unprecedented Government intervention provides opportunities.

The Fed's \$300b Treasury purchase plan will only be the start

Within the Treasury market, the bold actions of the Federal Reserve to begin quantitative easing led to strong returns following the mid March announcement. This rally proved to be short lived as investors continue to struggle on one side with the record supply issuance and poor long term fundamentals, and on the other the significant deflationary and recessionary aspects of this period. The implications following the Fed's purchase announcement are that with record supply issuance forthcoming, ***the Fed's announcement of \$300b purchase will only be the start of their purchase plan.***



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With Treasury yields once again reaching pre-announcement levels, the Fed, to have a significant impact on yield levels, will be forced to increase purchases beyond the initial amount. **Officials have made clear their intention to increase all available resources to prevent deflation. If the current measures are not enough they will increase the size of the outstanding actions until economic growth stabilizes. Thus Treasury yields are likely to remain range bound and low for an extended period of time.**

We continue to remain cautious on credit, with a neutral weighting

Corporate securities underperformed relative to other asset classes for the quarter. At the beginning of the year, many investors viewed investment grade credit as excessively 'cheap'. This forecast of excess returns was based on high relative spread levels. This view continues to be challenged, due in part to the continued uncertainty towards defaults, rating migration, liquidity, and a very sizeable new issuance pipeline. In particular the financial subsector of the corporate index underperformed due to lingering nationalization concerns and whether senior debt holders in systemically important institutions will suffer principal loss in any nationalization. We highlighted our views on credit in a recent research piece by Graham McDevitt, CIO of Credit Strategy ([paper can be accessed via our website](#)). While the relative valuations versus other sectors is appealing and we have moved our long held underweight in credit to a neutral weighting, we continue to remain cautious, leery of historical data used as relative value indicators.

Key portfolio themes

Sector rotation, under to neutral weighting in Treasuries added to performance

- > Underweight Treasuries across all strategies
- > Overweight Agencies (Fannie Mae/Freddie Mac)
- > Slight overweight in duration relative to benchmarks
- > Yield curve positioning focusing on a steepening of the yield curve
- > Within investment grade portfolios, neutral weighting to credit with overweight to senior bank debt

Government only mandates – we were significantly overweight Agencies and underweight Treasuries. We ended March with no out of index Agency MBS positions in the portfolios. The new quantitative easing measures announced by Federal Reserve, helped returns during March, while the rise in Treasury rates from significantly overbought levels in December hindered returns.

Low duration mandates – we were significantly overweight Agencies and underweight Treasuries. The portfolios benefited throughout the quarter by short maturities, low duration and defensive positioning.

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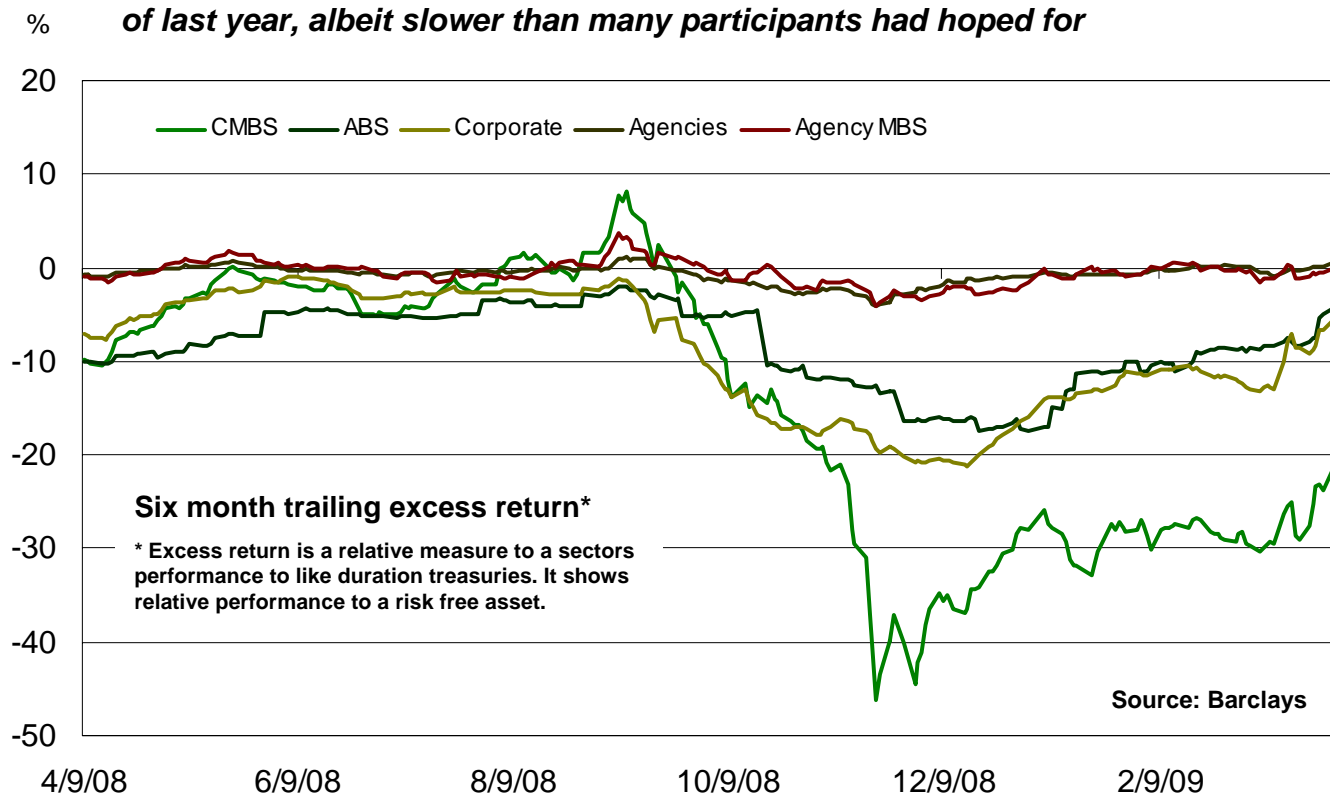
Agency MBS continue to drive performance in our strategies

AAA only Aggregate and Intermediate Aggregate mandates – we were overweight Agencies, neutral Agency MBS and underweight Treasuries. For the AAA only strategies the overweight in the Agencies, Agency MBS and no credit exposure helped performance of these portfolios in March. Agency MBS continue to drive performance contribution (as a % of total return) as the sector is the focal point of many of the Fed's initiatives. In addition, security selection in Agency MBS focusing on seasoned vintages and lower refinancing risk was a benefit to portfolios for the quarter.

An overweight to senior bank debt was a detractor from performance for the quarter

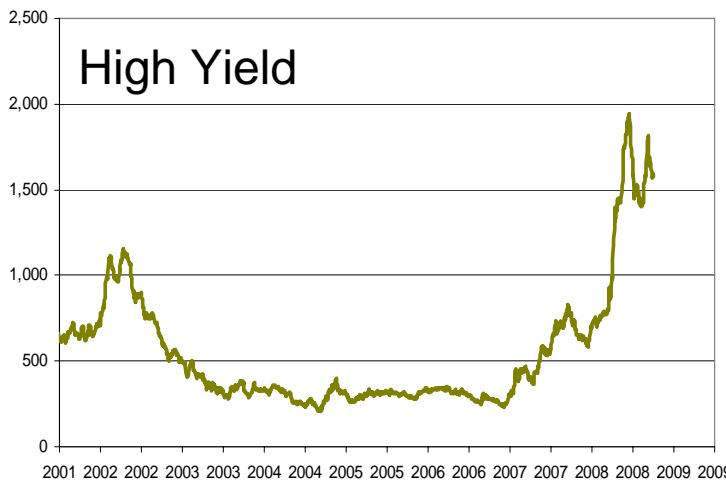
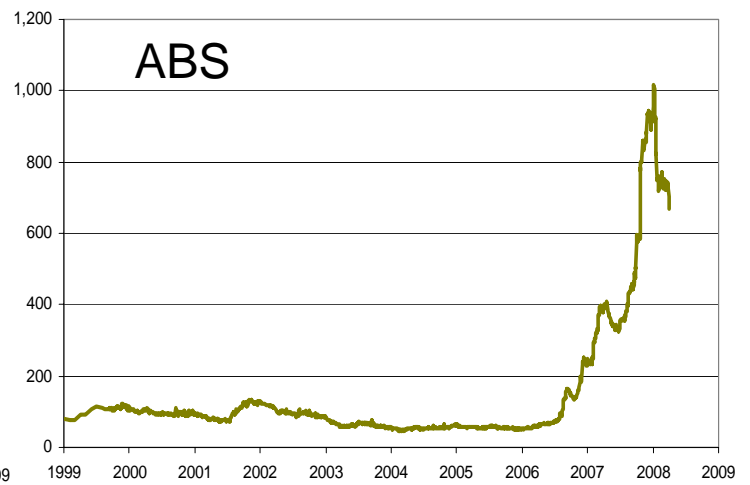
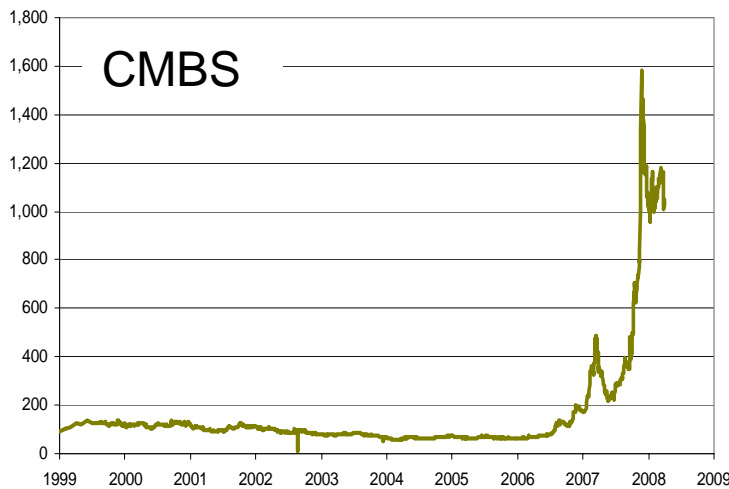
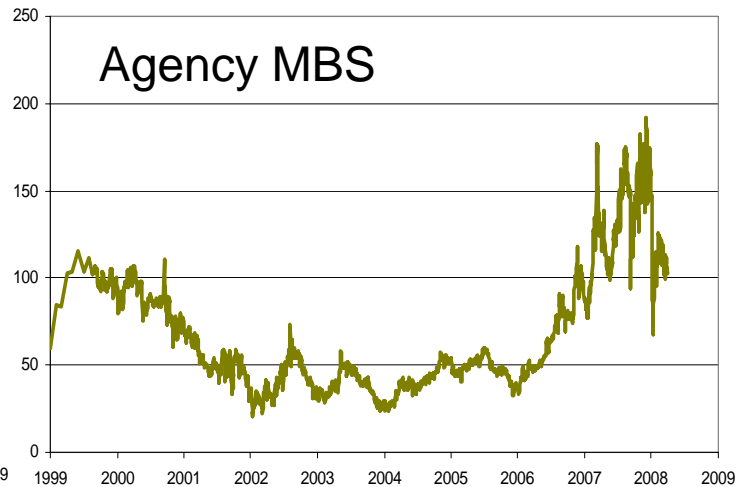
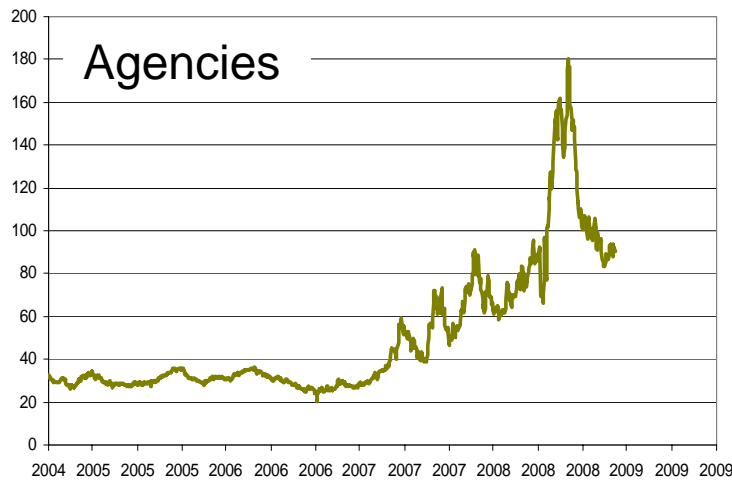
Aggregate investment grade mandates – we were overweight ABS and Agencies, neutral in Agency MBS, Corporates and underweight Treasuries and CMBS. Allocations and security specific positions in credit and ABS hindered performance in March and during the quarter. For the quarter, we reduced our ABS overweight. Our overweight to senior bank debt was a negative to performance throughout the quarter as the sector continues to struggle with lingering nationalization concerns of the systemically important financial institutions. We continue to focus our credit exposure in senior bank debt, utilities, and health care. Zero weighting in insurance companies.

Credit related sectors continue to improve from the severe oversold levels of last year, albeit slower than many participants had hoped for





Quarter end spreads of the major fixed income sectors



Source: Barclays

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| Economic Indicators | Current Mar-09 | Prior Feb-09 |
|--------------------------------|-------------------|-----------------|
| ISM | 35.8 | 35.6 |
| ISM prices paid | 29.0 | 29.0 |
| Factory Orders | -1.9% | -4.9% |
| Unemployment Rate | 8.1% | 7.6% |
| Change in NFP | -651K | -655K |
| Trade Balance | -\$36.0B | -\$39.9B |
| Producer Price Index (PPI) MoM | 0.1% | 0.8% |
| Core* PPI MoM | 0.2% | 0.4% |
| Consumer Price Index (CPI) MoM | 0.4% | 0.3% |
| Core* CPI MoM | 0.2% | 0.2% |
| CPI YoY | 0.2% | 0.0% |
| Core* CPI YoY | 1.8% | 1.7% |
| Retail Sales less Autos | 0.7% | 1.6% |
| Industrial Production | -1.4% | -1.9% |
| Capacity Utilization | 70.9% | 71.9% |
| UoM Confidence | 57.3 | 56.3 |
| Housing Starts | 583K | 477K |
| Leading Indicators | -0.4% | 0.1% |
| Consumer Confidence | 26.0 | 25.3 |
| S&P/Case-Shiller Comp-20 YoY | -19.0% | -18.6% |
| New Home Sales | 337K | 322K |
| Durable Goods Orders | 3.4% | -7.3% |
| Chicago Purchasing Managers | 31.4 | 34.2 |

*Less Food and Energy

Source: Bloomberg

| Financial Indicators | Current Mar-09 | Prior Feb-09 |
|----------------------|-------------------|-----------------|
| Oil | 49.61 | 44.37 |
| CRB | 220.32 | 211.75 |
| JOC | 67.02 | 67.55 |
| Yen to Dollar | 99.10 | 97.83 |
| Euro to Dollar | 1.3283 | 1.27 |
| DX | 85.85 | 88.14 |

| Quarterly Economic Indicators | Current** 4Q08 | Prior 3Q08 |
|-------------------------------|-------------------|---------------|
| GDP - Real QoQ | -6.3% | -0.5% |
| GDP - Real YoY | -0.8% | 0.7% |
| GDP - Nominal QoQ | -5.8% | 3.4% |
| GDP - Nominal YoY | 1.2% | 3.3% |
| Non-Farm Prod QoQ | -0.4% | 1.5% |

| On the Run Treasury Yields | Current Mar-09 | Prior Feb-09 |
|----------------------------|-------------------|-----------------|
| Fed Target Rate | 0.25% | 0.25% |
| 2-year | 0.80% | 1.01% |
| 5-year | 1.67% | 2.02% |
| 10-year | 2.68% | 3.03% |
| 30-year | 3.55% | 3.71% |

** subject to change.

Source: Bloomberg

| Barclay's Index Information | Duration | March | YTD | Sector Excess Returns | Current Month | YTD* |
|-----------------------------|----------|-------|-------|-----------------------|------------------|-------|
| Aggregate | 3.73 | 1.39 | 0.12 | Agency | -0.34 | 0.36 |
| Govt/Credit | 5.21 | 1.10 | -1.28 | Corporate | -2.61 | -0.21 |
| Government | 4.86 | 1.82 | -0.99 | CMBS | 4.62 | -1.42 |
| Intermediate Aggregate | 2.84 | 1.35 | 0.91 | ABS | 0.92 | 7.66 |
| Intermediate Govt/Credit | 3.84 | 0.95 | -0.05 | MBS | 0.44 | 1.72 |
| Intermediate Government | 3.61 | 1.38 | -0.08 | | | |
| 1-3 Year Govt | 1.84 | 0.53 | 0.32 | | | |
| U.S. MBS | 1.54 | 1.42 | 2.20 | | | |
| Corporate | 5.96 | -0.41 | -1.93 | | | |
| Majors Govts (ex U.S.) | 6.77 | 2.17 | -5.87 | | | |
| High Yield Bonds | 4.10 | 3.19 | 5.98 | | | |
| Emerging Market | 5.92 | 4.15 | 4.75 | | | |

Source: Barclays * YTD is period 01/01/09-3/31/09

Source: Bloomberg

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