

Macquarie Allegiance

Fixed Income Commentary | May 2009



Will rising bond yields and oil prices wilt green shoots?

Improvement in economic indicators led to further risk taking in the capital markets

In May, continued economic improvement and outperformance of risk assets instigated rumblings of a V-shaped recovery, meaning one that is quick and followed by a sharp improvement in GDP. While it is true the economic data improved, Macquarie Allegiance feels the outlook for the consumer remains questionable. Recent rising oil prices and mortgage rates puts further headwinds to this balance sheet recession. As measured by GDP, with 70% of the U.S. economy represented by the consumer, the recent 'Green Shoots' could be premature in signaling an all clear for the economy and capital markets.

With systemic risk diminished, credit outperformed with a Treasury sell-off

Back to a prolonged recession, not depression

Many leading indicators improved in May, with many bouncing off historic lows such as: ISM, PMI, and consumer confidence. As discussed in previous commentaries, it would have been impossible for manufacturing and trade to continue to contract at the levels seen in the 4Q08 and 1Q09. The improvement over the past two months must be recognized as a removal of the depression like scenario being priced into the first quarter. From the events of Lehman Brothers in September to mid-March, the environment was one of near systemic collapse and asset prices reflected default and recovery assumptions on level with the Great Depression (in 1932 Moody's investment grade default rate was 9.2%). Over the course of the past two months we have seen, globally, the Government guarantee programs and liquidity schemes begin to take hold and improve systemically the banking system. This, coupled with improving confidence that the worst is behind us, led to renewed risk taking.

Discretionary income is being hit by further headwinds

While many manufacturing and business indicators improved, the consumer outlook continues to weaken. Unemployment, retail sales and home prices are contracting while discretionary incomes are being sapped by rising mortgage rates and oil prices. Home prices reaccelerated to the downside as the Case Schiller home price index shows a year-over-year decline of 18.7%. In addition, the prime mortgage rate is now higher than before the announcement of U.S. Government policies at the end of last year, a concerning development for indebted American households and hopes of lower mortgage rates improving home prices and reducing foreclosures.

Rising oil prices are coming at the worst time for discretionary income

The continued rise in oil prices must be looked at with alarm for the consumer. Since the end of 2008, oil prices have doubled, directly impacting discretionary income and its ability to create pent up demand (through higher savings rates) in any recovery. **Rising oil prices could prove the antithesis to any second half recovery and green shoots as much as rising mortgage rates, due to the reduction in disposable income for consumers.**

All told, capital markets continued to recover out of the Great Depression scenario envisioned in the first quarter. This recovery has led to an impressive rebound in prices in high yield, bank loans, and lower rated securities. For the three months ending May, the Barclays High Yield index returned 23.46%, the greatest three month return period in the index's history (source Barclays).

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Rising oil prices and mortgage rates could be the end of green shoots

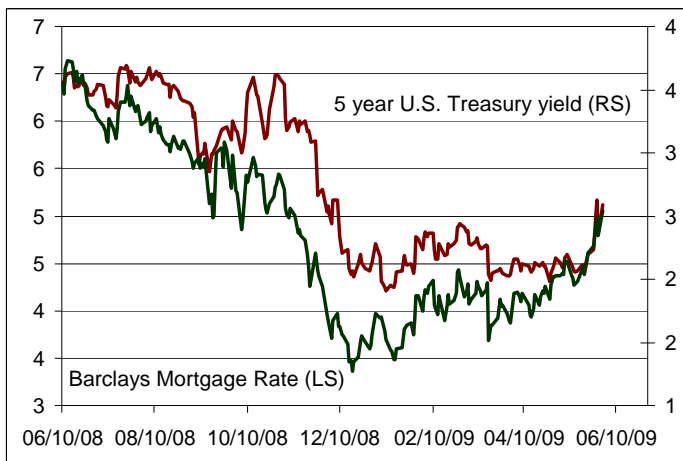
While expectations are increasing for a sharp improvement in the second half of this year, we cannot reconcile rising mortgage rates, oil prices and unemployment with the continued decline in housing as being indicative of a summer/fall recovery. We are at an important moment in this cycle, where enthusiasm for 'less bad' economic information has revised expectations. But the cyclical headwinds of a balance sheet recession are now being exasperated by the forces curtailing discretionary income. Getting the consumer right in the U.S. is key to taking a macro position on economics and with the factors discussed earlier, the consumer outlook is mediocre at best.

No clear upward trend will develop without the consumer

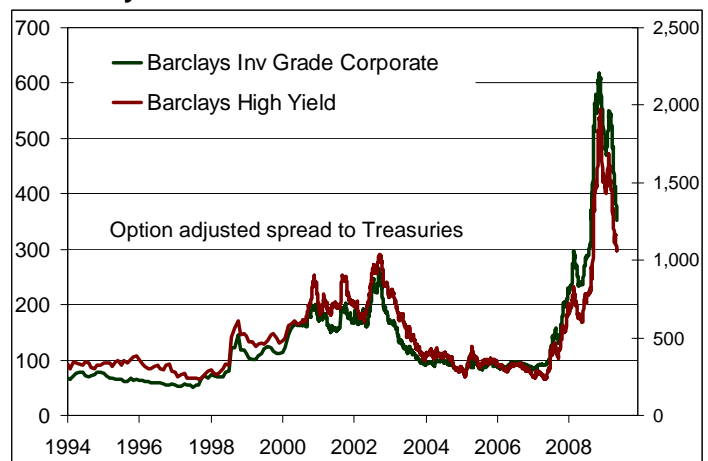
The second half of this year is sizing up to be one of fits and starts of economic activity, with no clear upward trend. The recent rise in mortgage rates and Treasury yields, and the reluctance of Fed policy officials to discuss this action is of equal importance. Further rises in yields will continue to push Government action as a balance sheet recession will be prolonged with higher real and nominal interest rates.

An extended period of deleveraging and subtrend economic growth remains our base scenario. Recent enthusiasm for 'less bad' economic information and a quick recovery could prove short lived.

Mortgage rates rose with Treasury Yields in May



Strong returns seen in credit related sectors in part from the increasing optimism of a second half recovery



Source: Barclays

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Current portfolio positioning

- > Underweight Treasuries, overweight Agencies and Agency MBS
- > Duration of portfolio's remains defensive and below benchmarks
- > Yield curve positioning focused on a steepening of rates
- > Within investment grade portfolios, continued gradual increase in credit exposure to above benchmark

Agency MBS were added to the Government indexed portfolios

Government only mandates – We continue to maintain significant underweight to Treasuries and overweight to Agencies versus our benchmark target. This positioning has served the portfolio's well for the year as interest rates have moved higher throughout the yield curve. For the first time this year, we added an allocation to Agency MBS as an out of index trading opportunity.

Low Duration mandates – Defensive positioning and low duration, with an overweight to Agency securities relative to the index.

MBS continue to drive performance due to high yields and low durations

AAA-only Aggregate and Intermediate Aggregate mandates - we were overweight Agencies, overweight Agency MBS and underweight Treasuries. Portfolio's overweight to Agency MBS was increased following the end of May sell off in Treasury rates and related mortgage servicer selling, in our view, providing attractive entry points. For the year, Agency MBS continue to drive performance for the strategy because of their high yields relative to durations, which are short (2-4 years). We continue to favor selected securities in Agency MBS with low refinancing characteristics.

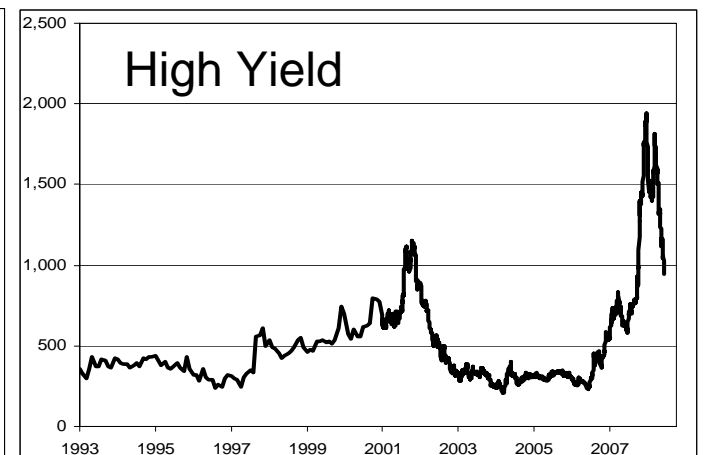
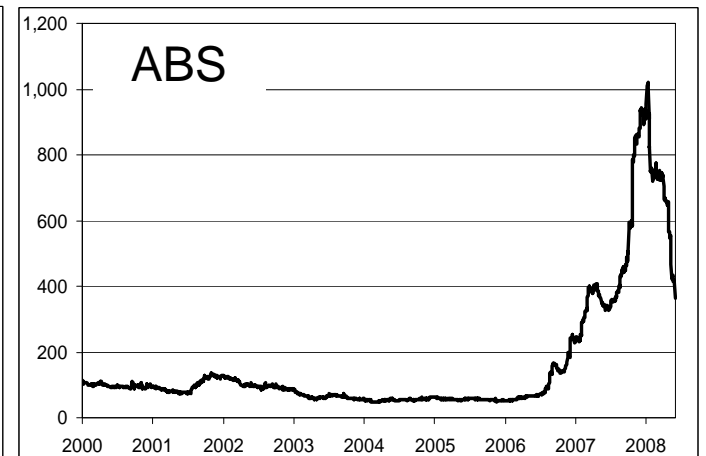
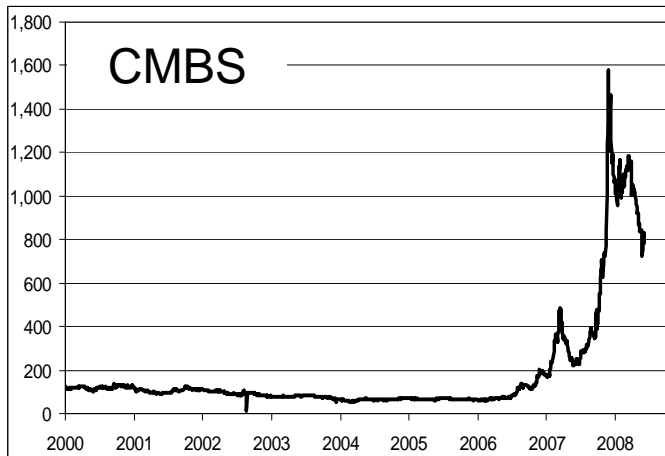
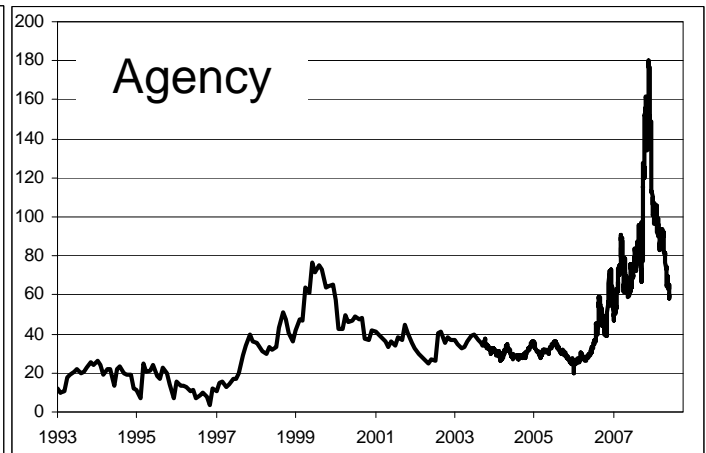
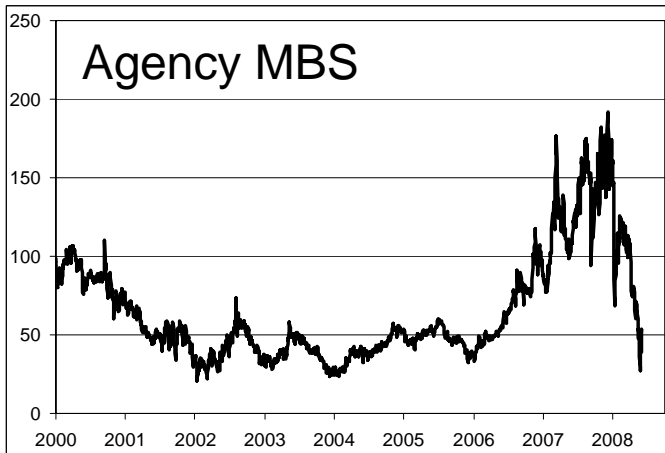
Our overweight to senior bank debt was a positive in May

Aggregate investment grade mandates – we were overweight Agencies, overweight Agency MBS, overweight Corporate, overweight ABS, underweight Treasuries and CMBS. Improvement in risk appetite benefited the strategy as credit related sectors outperformed, in particular our overweight to senior bank debt. We have further reduced our ABS overweight and continue to look for selling opportunities as the market allows. We continue to be buyers of new issue corporate securities, gradually increasing our overweight, generally in healthcare, financials and industrials.

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Month-end spreads of the major fixed income sectors



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Economic Indicators	Current May-09	Prior Apr-09
ISM	40.1	36.3
ISM prices paid	32.0	31.0
Factory Orders	-0.9%	0.7%
Unemployment Rate	8.9%	8.5%
Change in NFP	-539K	-699K
Trade Balance	-\$27.6B	-\$26.1B
Producer Price Index (PPI) MoM	0.3%	-1.2%
Core* PPI MoM	0.1%	0.0%
Consumer Price Index (CPI) MoM	0.0%	-0.1%
Core* CPI MoM	0.3%	0.2%
CPI YoY	-0.7%	-0.4%
Core* CPI YoY	1.9%	1.8%
Retail Sales less Autos	-0.5%	-1.2%
Industrial Production	-0.5%	-1.7%
Capacity Utilization	69.1%	69.4%
UoM Confidence	68.7	65.1
Housing Starts	458K	525K
Leading Indicators	1.0%	-0.2%
Consumer Confidence	54.9	40.8
S&P/Case-Shiller Comp-20 YoY	-18.7%	-18.7%
New Home Sales	352K	351K
Durable Goods Orders	1.9%	-2.1%
Chicago Purchasing Managers	34.9	40.1

*Less Food and Energy

Source: Bloomberg

Financial Indicators	Current May-09	Prior Apr-09
Oil	66.21	51.13
CRB	251.87	222.40
JOC	78.61	71.79
Yen to Dollar	95.14	98.66
Euro to Dollar	1.4133	1.3261
DX	79.45	84.83

Quarterly Economic Indicators	Current** 1Q09	Prior 4Q08
GDP - Real QoQ	-5.7%	-6.3%
GDP - Real YoY	-2.5%	-0.8%
GDP - Nominal QoQ	-3.1%	-5.8%
GDP - Nominal YoY	-0.4%	1.2%
Non-Farm Prod QoQ	0.8%	-0.6%

On the Run Treasury Yields	Current May-09	Prior Apr-09
Fed Target Rate		0.25%
2-year	0.92%	0.91%
5-year	2.34%	2.02%
10-year	3.47%	3.12%
30-year	4.33%	4.04%

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

Source: Bloomberg

Barclay's Index Information	Duration	Monthly Return	YTD
Aggregate	4.14	0.73	1.32
Govt/Credit	5.18	0.80	-0.30
Government	4.71	-0.76	-3.04
Intermediate Aggregate	3.33	0.69	2.27
Intermediate Govt/Credit	3.87	0.74	1.15
Intermediate Government	3.61	-0.45	-1.25
1-3 Year Govt	1.85	0.26	0.60
U.S. MBS	2.60	0.29	2.79
Corporate	6.08	3.90	5.44
Majors Govts (ex U.S.)	6.61	4.45	-1.23
High Yield Bonds	4.34	6.73	26.80
Emerging Market	6.08	4.53	15.64

Source: Barclays

Sector Excess Returns	Current Month	Year-to- Date
Agency	0.44	1.54
Corporate	5.08	10.17
CMBS	4.42	11.87
ABS	5.76	15.91
MBS	0.61	2.82

Swap Spreads	May-09	Apr-09
2-yr	40	56
5-yr	43	55
10-yr	19	12
30-yr	-32	-42

Source: Bloomberg

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