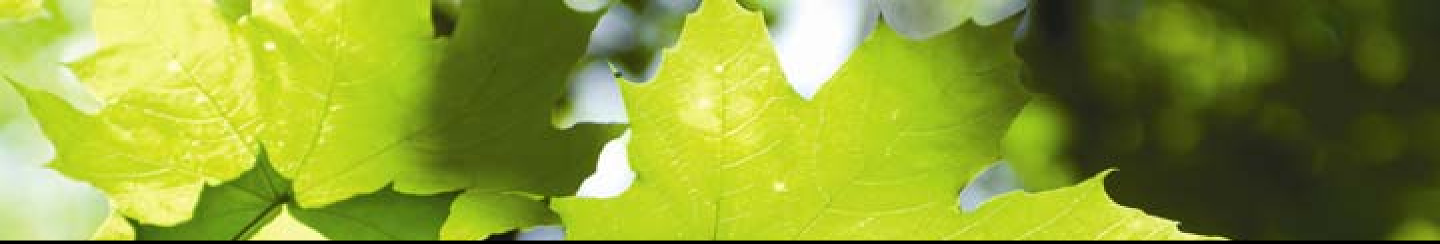

Macquarie Allegiance

Fixed Income Commentary | January 2011

MACQUARIE

Happy New Year

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While 2010 was ultimately a good year for risk assets, the ‘ride’ felt like a rollercoaster. The year started off with such optimism, but the path was potted with some big dips and violent twists and turns. However, when we got to the end and looked at the bottom line we smiled and thought it was a lot of fun. In planning our strategy for 2011 the image of the rollercoaster looms large, seeing many of the same dips, twists and turns, yet I believe the ‘ride’ this year will be significantly different.

Optimism has increased for a sustained US recovery through 2011.

Themes and risks facing investors in 2011

1. The Economy

During the last 3-4 months of 2010 the trend of economic data was consistently better-than-expected. This was the case for global data and particularly for US data (see chart 1). This correlated with the announcement by the Federal Reserve for round two of quantitative easing (though QEII did not actually start until 4 November). The consequence of this measure of economic surprise is that economists and equity analysts have been gradually upgrading their forecast for 2011. Consensus now sees US GDP at around 3% for 2011[1].

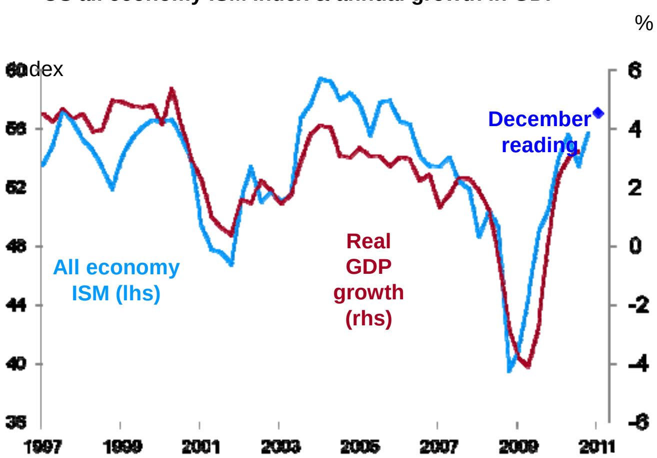
The latest All Economy ISM (where we weight Services 80% and Manufacturing 20%) was 57.1 for December, up from 55.0 the previous month and 52.5 in August (see chart 2). Our economist Lewis South commented that ‘if sustained, a literal interpretation of this reading would be consistent with annual GDP growth of around 4.5%. This would be a big positive surprise to current economic consensus’. However, Lewis went on to note that even if we assume a 4.5% growth rate is sustained in future years, this economic recovery will still be weak by historic standards.

Housing remains weak, and the recent back up in rates hasn’t helped the outlook. Capacity utilization rates are rising, but remain low relative to previous cycles of recovery. This largely explains why employment has been so slow to respond, as firms have been able to increase production by increasing the hours worked of their existing staff rather than increase hiring.

Chart 1: US Data better than expected
Cumulative US data surprise index (June 30, 2007= 0)
(see definition on page 3)

Source: Macquarie

Chart 2: Surveys point to an acceleration in growth
US all economy ISM index & annual growth in GDP



Source: Thomson Financial Datastream & Macquarie

[1]From “Consensus Economics” publication

2. Fed Policy and Rates

Despite better growth prospects we expect the Fed to delay the realignment of short term interest rates until 2012.

We agree with the assessment of the Fed[2] that this recovery is still not self sustaining and therefore expect that short term rates will remain unchanged through this year.

That said, the rates market is on high alert for higher rates. We have warned on several occasions that as money markets and credit markets normalize the risk for higher interest will rise…and, that history suggests that this realignment of market interest rates will be rapid. The 100bp rise in 10Y rates between October and early December is evidence of this. Our long term valuation models continue to stress that bond yields will eventually move higher. However, our shorter term valuations suggest that 10Y yields around 3.25-3.50% should offer support, as (i) the extreme curvature distortion induced by QEII has unwound (see chart 3); (ii) that the yield curve is near its steepest levels, implying attractive carry and roll-down; and (iii) inflation pressures remain very subdued, which supports the outlook for unchanged Fed Funds.

Given our structural bias on rates we were quick to re-position for the move in Q4'10. We are neutral now, but will remain on high alert for rising rates, where the short end of the curve is already massively expensive on our long term models, despite our belief that the Fed bias is to maintain low rates for longer to underpin the recovery.

3. Credit

We maintain an overweight view on credit.

We maintained a positive view on credit during 2010 and see no reason to change our outlook for 2011. Spreads have contracted and both Investment Grade and High Yield are now trading below their 10 year average. While we await the Q4 earnings reports, the bottom up outlook from the credit analysts remains very bullish: cheap funding; plenty of cash on balance sheets; and, reduced leverage. Despite this there are two concerns facing investment grade credit during 2011: (i) increasing evidence of equity friendly activity; and (ii) with low spreads, total returns will increasingly be driven by moves in the level of interest rates. So, we remain overweight credit with analysts focusing on avoiding the name specific risks that are expected to buffet the market during the year ahead.

Our biggest risk concern is focused on European banks, which are not yet capitalized sufficiently to quell investor concerns. We believe market participants are more attuned to the problems in Europe than one year ago, however, the specter of bank risk still overhangs the market which is positioned long risk.

4. Sovereign and Emerging Markets

European sovereign problems will remain an on-going 'noise' for risk markets, though risk of default is low in 2011.

The carnage in peripheral European sovereign spreads dominated 2010. This theme remains in play. Greece, then Ireland have been pounded by the markets concern over fiscal sustainability and as a result have been bailed out by the EU/IMF/ECB. Portugal is not far away from enduring the same fate. The widening in these Sovereign spreads (see chart 4) did cause credit spreads to widen during 2010, but as markets dislocated the two events, the correlation risks have diminished.

As we start 2011, with the funding and fiscal concerns still hounding peripheral Europe, focus has been on the narrowing of spreads between developed and emerging sovereigns (see chart 5). While actions are being gradually adopted to contain the fiscal problems in Europe, the scale is huge and the risks will be with us for some time to come. Many emerging market sovereigns, by contrast, have much improved credit dynamics and spreads have been adjusting accordingly. Several emerging economies are grappling with inflation pressures, and policy management is being finely balanced with a desire to restrict the appreciation of their domestic currencies.

Emerging market spreads have discounted the positive fundamentals. Domestically, inflation risk is the dominant theme.

Emerging market spreads look tight as compared to recent decades, but fundamentals supportive, so carry should continue to attract investor support (see chart 6). However, like investment grade credit, moves in the underlying level of rates will play an increasing part of the total return performance for emerging market bonds.

[2] From the latest Fed minutes

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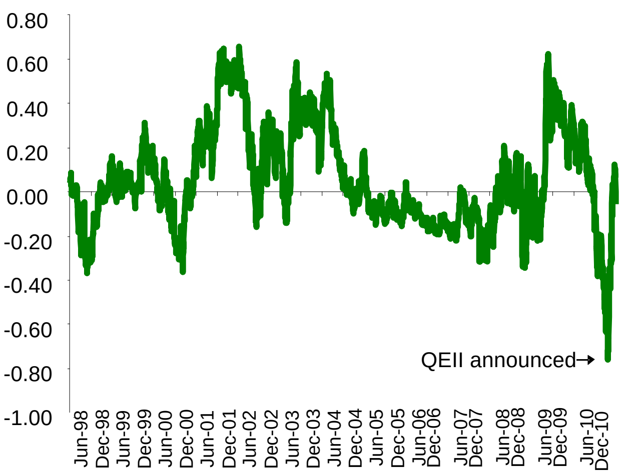
Investment strategy:

We spent the first week of January reviewing our views and positioning. Our conclusions were virtually unchanged from that of the last quarter. We maintain an overweigh credit exposure. We see 2011 generating attractive carry from credit rather than significant spread contraction. Our credit analysts emphasize name selection to navigate through the risks that credit will face during 2011. Our rates team is neutral on yields after the adjustment higher during Q4, however, our bias is bearish on the medium-to-long term. We therefore will be watching for signals to again react and shorten duration.

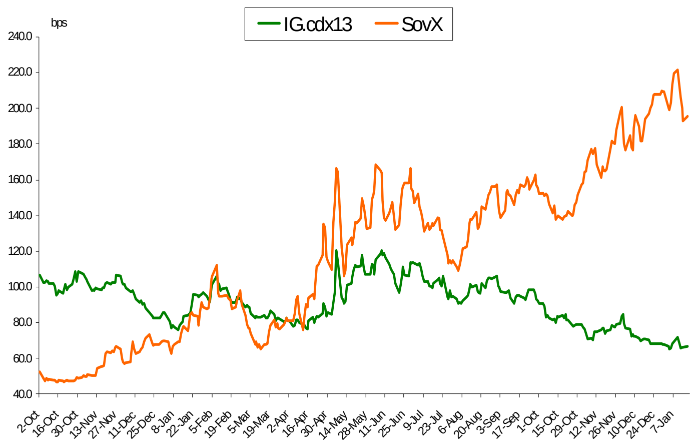
Definition: US data surprise Index is based on official released data and how it actually comes out relative to expectations. The index is calculated by Macquarie economists and is not a published index\\

Chart 3: US Curvature QE induced volatility US: 2-5-10Y



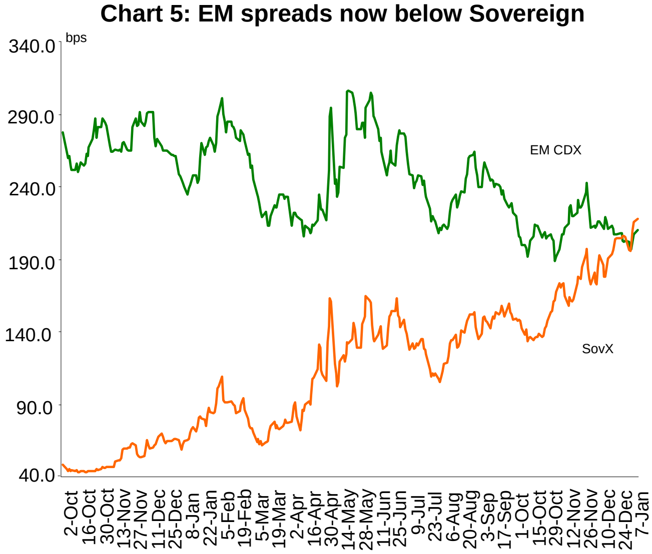
Source: Macquarie and Bloomberg

Chart 4: Sovereign Spreads and Investment Grade Credit



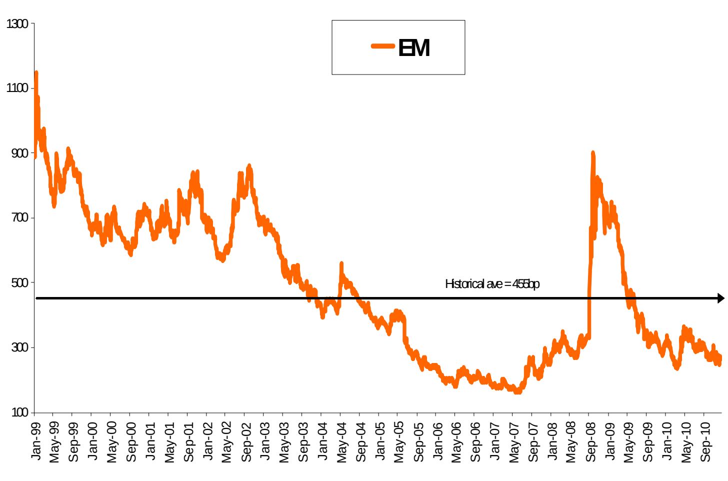
Source: Macquarie and Bloomberg

Chart 5: EM spreads now below Sovereign



Source: Bloomberg

Chart 6: US Data – Better than expected



Source: Macquarie and Barclays

Portfolio Positioning and Strategy

Our strategic duration position is to be short to flat the index

Macquarie Allegiance manages separate accounts, invested in 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: Short. A short position is warranted through the view interest rates are at the low end of the recent range and are trending higher. Technical analysis, an important part of our investment process, confirms the view interest rates are in a range in the near term but the main trend is toward higher rates.

Yield Curve: Underweight 5-7 year maturities. We positioned portfolios to benefit from 5-7 year maturities underperforming shorter and longer maturities. We flattened our exposure to the long end of the curve.

Treasury and Agency: Flat to short Treasuries, underweight Agencies. Our Treasury underweight is driven by our overweight in Agency MBS and near zero weighting in Agencies. We see Treasury rates modestly rising from today's low levels, in particular in the intermediate part of the Yield curve (5-7 years)

Selected coupons within Agency MBS are extremely attractive

Agency MBS: Overweight. Agency MBS valuations/carry look attractive as the market reprised for slower prepayment speeds due to the uptick in rates. Favorable prepayment speeds and limited duration continues to support higher coupon strategies. We're focused on a barbell coupon position, favoring 4%, 6% and 6.5% issues and avoiding belly coupons (4.5% - 5.5%).

Corporate Bonds: Overweight. We see 2011 generating attractive carry from credit rather than significant spread contraction. Our credit analysts emphasize name selection to navigate through the risks credit will face during 2011 including equity friendly M&A activity and greater volatility from rates. In our view, Corporate bonds remain attractive due to the strong bottom up sector fundamentals.

Structured Credit: Neutral ABS, Overweight CMBS: We continue to favor the sector looking longer term. However, given the run-up in prices going into yearend, together with CMBS fundamentals which show weakness in 2011, we are cautious on the sector currently, but expect to find opportunities on a pool and bond-specific basis.

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