Macquarie Allegiance

Fixed Income Commentary | February 2011

MACQUARIE

Graham McDevitt
Global Head of Strategy
Co-Chief Investment Officer

4% again

Despite massive distortions in the January employment report the Treasury market continued its march toward 4% yield (again). This will be the third assault on the 4% level since the collapse in 10Y Treasury yields in late 2008 (to a low of just above 2%). See Chart 1

I have written many times about the risk of rising bond yields in this newsletter and it is appropriate to touch on the drivers we have previously identified. We have traded this move higher in interest rates from the short side, which is adding to performance. While we are long term bears on the outlook for interest rates in the US, we believe the process of normalization will be irregular. The below discussion summarizes our assessment of the current drivers of interest rates.

Why are yields heading higher?

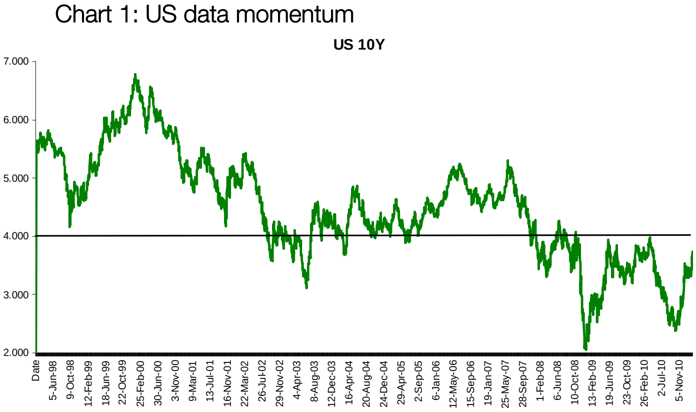
Recent data continues to support the view that the US economy will sustain a recovery through 2011.

1. It's the economy, stupid!
US economic data continues to beat expectations and importantly has maintained positive momentum; that is, the latest data point is stronger than the previous period. Chart 2 illustrates the data momentum trend for the US. Our measure of the All Economy ISM (80% services + 20% manufacturing) rose to 59.7 in January, which is a level that is consistent with GDP growth of 4.0-4.5%. With real disposable income growth still well below its average of the past three decades it has been a surprise to see real consumer spending post a strong gain in the month of December and for the Fourth Quarter 2010 as a whole. The answer lies with the rise in consumption coming at the expense of the savings rate. So it appears as though the consumer is starting to feel more confident about the future. This optimism was supported by a strong rise in underlying household employment in January, that pushed the unemployment rate down to 9.0% (from 9.5%).

This good news on the economy is fuelling speculation on the turn in the interest rate cycle. That said, at some point we need to see faster INCOME growth if the current pace of consumption is to be sustained.

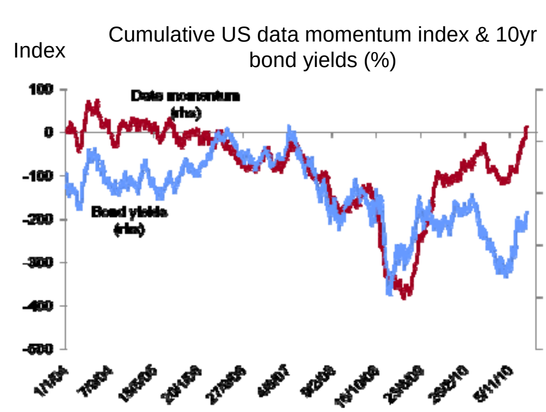
Bottom line, the better than expected trend of monthly economic data has been a key factor in pushing bond yields higher (see chart 2). But the correlation between data momentum and bond yields has fallen, suggesting that there are other significant influences at play.

Chart 1: US data momentum



Source: Bloomberg

Chart 2: US data momentum & bond yields



Source: Thomson Financial Datastream and Macquarie

Despite stronger growth and a surge in commodity prices there is no evidence of inflationary pressures.

2. But where is inflation?
The core PCE deflator was unchanged in the latest month, which has the annual growth rate slowing further to a new all time low (the data goes back to 1960) of 0.7%, (see chart 3). Whilst stronger growth is reducing the risk of deflation developing, the extremely low reading for inflation means the Fed is likely to allow faster growth to run its course, mindful that early tightening in Japan stifled a nascent recovery there and plunged the economy into a decade or so of deflation.

The concerns surrounding inflation principally reflect a rise in global commodity prices in recent months. Food and bulk commodity prices have all risen sharply of late (see chart 4). This is feeding through into business costs, which is evident in both the surge in the prices paid indices of both the manufacturing and services ISM surveys, but also in the Q4 earnings reports.

Inflation pressures are being contained by the persistence of a large negative output gap.

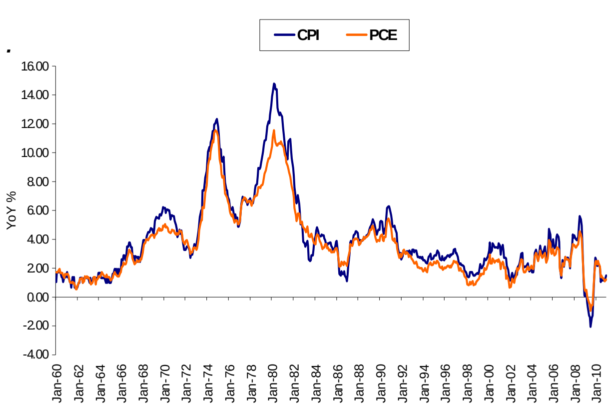
In the last two decades there has been a clear positive relationship between commodity prices and headline inflation in the US. Over this period, movements in commodity prices have tended to feed into headline inflation pretty quickly. However, since the onset of the global financial crisis this relationship has broken down – with current commodity prices suggesting headline CPI should be closer to 4-5% than the existing 1.5%. In the opinion of our economist, Lewis South, the breakdown in this relationship reflects the fact that the US economy is currently operating with an extremely large output gap (see chart 5). This has limited the ability of firms to pass on rising costs.

Conclusions:
Our analysis shows that the improving trend of the economy has been pressuring Treasury yields higher. The current macro momentum suggests we are heading for the third test of 4.0% on the 10Y yield in this cycle. However, inflation pressures in the US remain low despite the added pressure coming from surging commodity prices. We conclude that the persistence of a large negative output gap is helping to contain inflation pressures.

So, we can see 4% again, but higher 10Y rates will ultimately need the Fed to signal the end of ZIRP.

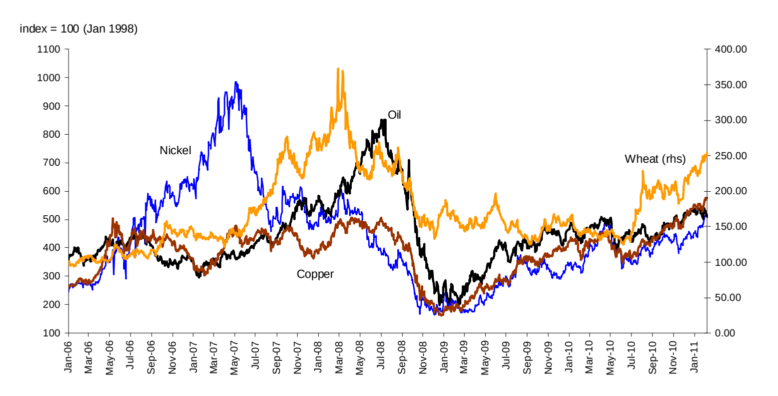
When our analysis is combined with the steepness of the US yield curve our conclusion is that it is unlikely at this time that 10Y yields will be embarking on a sustained sell-off beyond 4%. The key here is Fed policy. We expect the Fed to maintain the quantitative easing program through to its conclusion at end of June. While it is becoming increasingly unlikely that QEII will be sustained beyond that date it is still difficult to see the Fed actually moving to raise rates during 2011 while a negative output gap remains; inflation remains so low; and, the Fed belief that if they raise rates too early they risk repeating the mistakes of Japan and slip into deflation.

Chart 3: US Inflation history



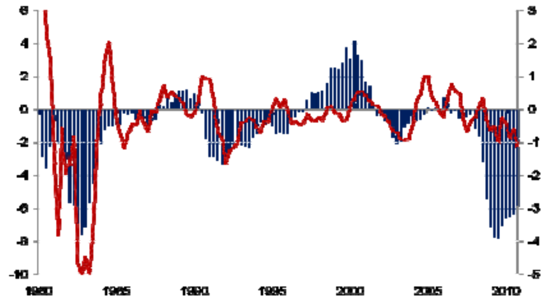
Source: Bloomberg

Chart 4: Commodity Prices (index 100 in 1998)



Source: Bloomberg

Chart 5: US – Output Gap & Core CPI (change in y/y growth)



Source: Thomson Financial Datastream, CBO & Macquarie

Strategy

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

The combination of rising bond yields fuelled by a strengthening economy, with inflation remaining low is, good news for risk assets. It is no surprise to us that equities continue their positive momentum. Credit spreads too are tightening, where Moody's have reported that there were no defaults in the month of January, for the first time since June 2007. We remain long risk assets and continue to look for opportunities to add risk selectively. We remain vigilant on the risk for higher Treasury rates, particularly as the lower spreads are giving less protection from the negative return pressure from rising bond yields.

Portfolio Positioning and Strategy

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.

A market breakout has us short to neutral on duration.

Duration: *Short*. A short position is warranted as our view is for higher rates. The market traded in a range since mid-December and has recently broken towards higher rates.

We have maturities positioned for a flatter curve.

Yield Curve: *Underweight 5-7 year maturities.* The portfolios are positioned to benefit from 5-7 year maturities underperforming shorter and longer maturities. We remain positive on longer maturities as the yield curve continues to flatten - being led by intermediate maturities.

Treasury and Agency: *Underweight Treasuries, Underweight Agencies.* Our Treasury and Agency underweight is driven by our overweight in Agency MBS as well as our short position in duration.

We continue a large weighting in Agency MBS.

Agency MBS: *Overweight.* Going forward, we see lots of positives for MBS as an asset class, especially versus US Treasuries and Agencies. Valuations metrics and carry look attractive. Extension risk is generally priced in, judging by the shape of the stack, while prepayment speeds are expected to fall 30-40% over the next few months. Additionally, implied volatility in interest rates has room to normalize, reversing the spike recorded during 4Q10.

Agency MBS allocation is barbelled among coupons.

We're focused on a barbell position, favoring 4s, 6s and 6.5s over the belly of the coupon stack (4.5s through 5.5s). Low coupons such as 4s are essentially non-callable at these dollar prices. Premiums continue to benefit from credit impairment and burnout, which make them attractive carry vehicles in the front end of the curve. Belly coupons (5s and 5.5s), on the other hand, have unfavorable convexity profiles.

Portfolio Positioning and Strategy (cont'd)

Corporate bonds still provide an attractive coupon carry.

Corporate Bonds: *Overweight.* We viewed 2011 as an attractive carry from credit rather than significant spread contraction. To date, investment grade spreads have contracted more than expected and the credit curve has flattened. Despite this, with the underlying structure of interest rates rising, the total return from owning investment grade corporates has been under pressure. 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.

CMBS still offer potential spread tightening.

Structured Credit: *Neutral ABS, Overweight CMBS:* Year-to-date 2011 has demonstrated the degree of positive technicals in the CMBS sector. Spreads have rallied across the credit spectrum. The new issuance fixed-rate CMBS is up and running and recent transactions have been met with overwhelming investor demand. Investor demand for CMBS is being driven by 1) improving liquidity and security value trends, 2) improving sentiment towards macro and CRE specific fundamentals and 3) relative value vs. other fixed-income asset classes. Year-to-date performance in CMBS has caused the relative value argument to be less obvious but we feel it remains.

MACQUARIE

Macquarie Allegiance Capital, LLC
555 South Flower Street, 33rd Floor
Los Angeles, CA 90071

Client Services
213-233-4500

@ MFGClientServicesLA@Macquarie.com

www.MacquarieAllegiance.com