



Note

On April 1, 2011, Macquarie Allegiance Capital will be joining Delaware Investments, a fellow member of Macquarie Group. **Beginning next month, this newsletter will not be e-mailed directly to you, but instead will be available on the Delaware Investments website at: www.DelawareInvestments.com/co/delaware/individual-investors/products/managed-accounts.** Macquarie Allegiance thanks you for your continued interest and support of its investment strategies that will soon be renamed under Delaware Investments.

Graham McDevitt
Global Head of Strategy
Co-Chief Investment Officer

Performance recap

To date 2011 is proving to be a challenging year. On the one hand, the macro economic data has continued to come better than expected and the bottom up earnings information reveal a corporate balance sheet picture that is in very good health. On the other hand, financial markets are having to endure heightened concerns about sovereign risk, particularly in peripheral Europe, but there are also longer term concerns over the fiscal/debt health of both the UK and the United States. More recently, tensions have escalated in the Middle East and North Africa that have worked to push oil prices to uncomfortably high levels. Elsewhere, food prices are ratcheting higher on several specific supply and demand imbalances. This combination is raising inflation concerns and fears about corporate margins being further squeezed. Finally, in recent days we have had to digest the tragic events in Japan.

So far, risk markets have weathered the storm of negative headlines particularly well. The very robust macro picture is clearly lending significant support to bullish investors into both equities and credit. For interest rate markets, the negative headwinds have likely helped to reverse the otherwise strong pressures for higher yields.

We have held our nerve on credit markets and in fact are viewing wider spreads as corrections and therefore an opportunity to selectively add risk. In terms of managing duration, where we have had a clear bias to manage our assets short of benchmark, the recent events initially induced a move back to neutral and more recently, to actually position long of benchmark. Adding duration to a portfolio that is long credit makes sense in these turbulent times as it provides investors with a better balance of risk. As at the end of February 2011, we are maintaining a modest outperformance against benchmark, posting most of that gain in the past month.

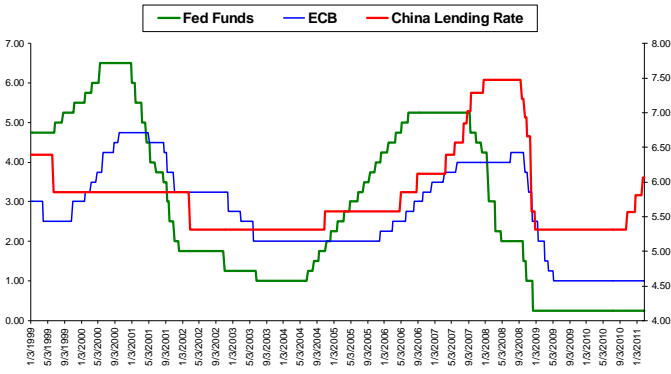
The Fed is looking increasingly isolated in persisting with a highly stimulatory policy bias.

Central Bank Watch

A lot of attention is on the Federal Reserve policy outlook, unsurprisingly because the economy is proving strong and the second round of quantitative easing is scheduled to end in June 2011. However, an international perspective would suggest that the Fed is no longer leading global policy; in fact the Fed is likely to be the next to last major developed country central bank to tighten monetary policy.

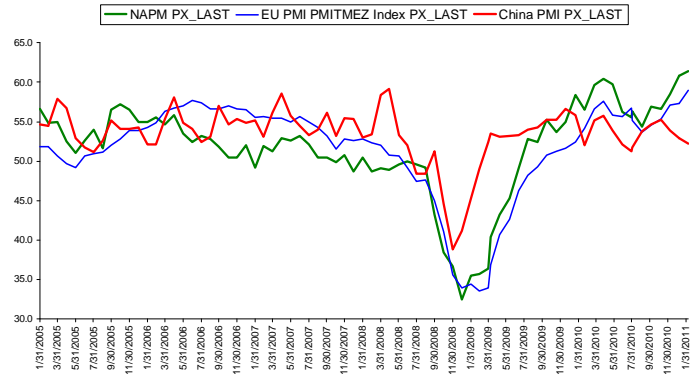
In Chart 1, I show key policy rate levels for the US, Euroarea and China since 1999 (when the European Central Bank (ECB) came into effect). This chart illustrates four clear cycles of monetary policy, two hiking cycles and two cutting cycles. It is easily observed that during each of those four cycles the Fed has led the way. However, the current cycle, the fifth under observation, is different: China has already moved to hike rates 3x 25 basis points (bp) starting in October 2010; the ECB just last week sent a clear signal to financial markets that it is likely to hike (1x 25bp) in April 2011, while the markets are discounting around 3x 25bp of hikes in total during 2011; in contrast, Mr. Bernanke – ignoring clear dissent from some of his colleagues – in his testimonies to Congress stated that Fed policy will remain at highly stimulatory levels.

Chart 1: Key Policy Rates: US, China, Euroarea



Source: Bloomberg

Chart 2: PMI Trends: US, China, Euroarea



Source: Bloomberg

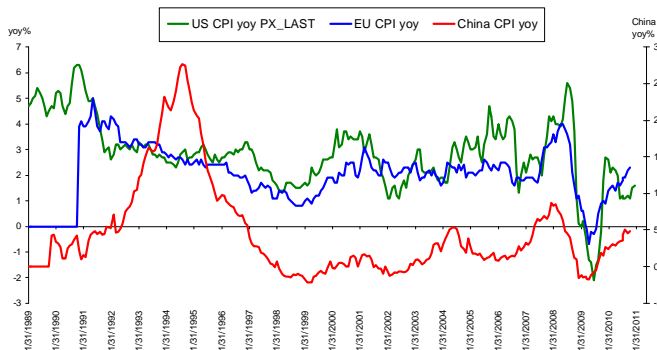
Comparing economic cycles

Chart 2 illustrates manufacturing data for the US, Euroarea and China based on the Purchasing Managers Index (PMI). Broadly the cycles have been highly correlated. However, it is noticeable that China's downturn in response to the Global Financial Crisis (GFC) was both later and shallower than that of the US and the Euroarea. In addition, China bounced much quicker than both the US and Euroarea. The different cycle of China partly reflects the massive fiscal response from its authorities (roughly 3x that of the US) and the already buoyant domestic economic environment pre-GFC.

With China having already raised interest rates 3x 25bp, in combination with other monetary tightening measures, the impact on growth is gradually having an impact. Thus, recent monthly PMI data from China is clearly slowing while data from both the US and Euroarea continues to accelerate.

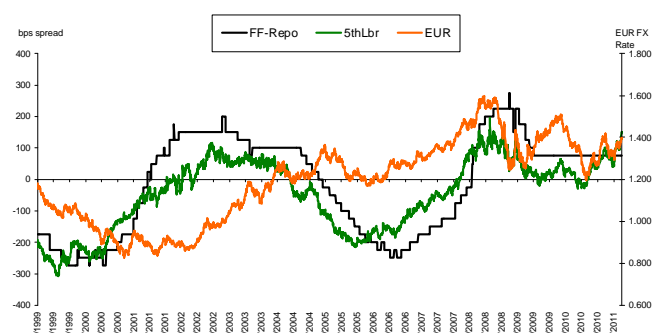
We can look at the contrasting inflation picture between these three countries in Chart 3. I have selected headline CPI (Consumer Price Index) year-on-year for this purpose so as to capture the broadest impact of inflationary pressures. Both China and EU inflation are in rising trends. Both central banks have recognized this trend. China has already responded and the ECB looks set to follow suit. Both central banks are choosing not to be overly focused on core inflation, seeing the risk with a broad based global recovery gathering momentum that trend in food and energy prices can filter into broader inflation pressures.

Chart 3: Inflation: US, China, Euroarea



Source: Bloomberg

Chart 4: US & EU: Interest Rate Spreads and FX



Source: Bloomberg

While economic cycles have broadly been in sync, there is increasing divergence of late.



The Fed is focused on core inflation while China and EU central banks fear inflation pressures could broaden.

Again, in contrast, the US Federal Reserve is ignoring the broad inflation signal coming from overall CPI, choosing to emphasize the still low level of core inflation. History will tell whether the Fed is making a grave mistake or in fact it has navigated the tail end of the GFC with skill. Whatever the result, we are entering a period of divergence between these three countries.

We can look at how financial markets are assessing these policy divergences in Chart 4. Here we are looking at the official policy spread (in bps) between the US Fed and the EU ECB; the spread between future interest rates expectations (using the 5th libor future contract); and the EUR exchange rate. While the official interest rate spread has remained unchanged since May 2009, the future expectation of policy divergence began a new trend in the summer of 2010 – when the Fed signaled that it would extend its offering of unconventional policy, that is quantitative easing (known as QEII). The 5th libor spread has widened more than 150bp since summer 2010 as the markets discount increasing policy divergence between the US and the EU.

Since the Fed announced QEII the EUR exchange rate has appreciated. This has caught many investors by surprise as problems in periphery European sovereigns and in European banks have dominated headlines with a steady stream of negative news. Clearly, the yield spread matters, as the correlation illustrates in Chart 4. There could be other issues at stake, such as a loss of confidence in US policy makers, and/or diversification of foreign exchange reserves by global central banks. The net result is that the trade weighted dollar is hovering precariously close to its all time lows.

Investment implications

It is very difficult to assess the impact of the tragedy in Japan on its own economy or the implications on the global economy at this point. We are also amidst an uncertain environment stemming from political unrest in the Middle East and North Africa, which appears nowhere near a conclusion.

Locally, despite continuing evidence of improving economic growth the US Fed maintains a highly accommodative monetary policy stance. This position is in stark contrast to other central banks, where rate hikes are steadily being delivered around the globe, with Europe and potentially the UK to follow shortly. The persistence of so much liquidity and near zero rates continues to support investors holding risk assets.

In our view, credit remains a justifiable overweight against this macro and monetary backdrop. Credit is further supported by the latest Moody's report showing that the trailing 12-month speculative grade default rate was unchanged at just 2.8% in February and compares to 11.7% this time last year. Moody's baseline scenario forecasts the global default rate to fall throughout most of 2011 before ending December at 1.4%.

We expect the summer decision by the Fed on QEII to prove pivotal for our investment strategy

When we look ahead we see the summer proving pivotal for US investment strategy. QEII is scheduled to end in June 2011 and there seems little public appetite for the Fed to continue with its current policy approach. The removal of QEII is an effective 50-75bp of tightening (all things being equal). At present the economic data suggests the economy can handle this change. However, if oil prices sustain a move above \$100 per barrel, the economic data in 2-3 months time may make the Fed's decision much more difficult.

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.

Duration: *Short.* A short position is warranted as our view is for higher rates. The market broke out of its trading range towards higher rates in early February 2011, then by the end of the month it re-entered the range as geopolitical risks emerged. As such, we reduced our short duration position until those risks subside.

Yield Curve: *Underweight 5-7 year maturities.* The portfolios are generally positioned to benefit from 5-7 year maturities underperforming shorter and longer maturities. We remain positive on longer maturities and look for the yield curve 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.

Agency MBS: *Overweight. focused on barbell --> overweight premiums (6s and 6.5s), underweight belly coupons (5s and 5.5s), overweight 4s.* Premiums continue to outperform in both absolute and relative terms, a trend that has been in place since September 2010. Burnout, lack of supply, and credit impairment/muted prepayments remain the backdrop. Absent government intervention, an argument not supported by the tone of the Treasury White Paper, expect price action in higher coupons to grind tighter given their carry profile vs. other short duration alternatives. Belly coupons, especially 5s, have an unfavorable carry/convexity profile in our opinion. Discounts (4s and 4.5s) are attractive as compared to similar duration Treasuries, but roll-down still skews risk-reward in favor of Credit alternatives given the steepness of the curve.

Structured Credit: *Neutral ABS, Overweight CMBS:* We have used the back-up in CMBS spreads at the end of February and beginning of March of this year to begin to add additional exposure in recent vintage senior bonds. We have also sought to take advantage of the outperformance in new issue mezzanine CMBS bonds by trading out of a portion of our position there and into recent vintage senior bonds.

Important Information

The Purchasing Manager's Index is an indicator of the economic health of the manufacturing sector based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

The U.S. Consumer Price Index is a measure of inflation that is calculated by the U.S. Department of Labor, representing changes in prices of all goods and services purchased for consumption by urban households.

The London Interbank Offered Rate (LIBOR) is an interest rate at which banks can borrow funds from other banks in the London interbank market.



This communication is of a generic nature, intended for financial professionals and is for informational purposes only. Past performance is not indicative of future results. Fixed Income securities and bond funds can lose value and investors can lose principal as interest rates rise. They may also be affected by economic conditions that hinder an issuer's ability to make interest and principal payment on its debt.

The views expressed represent the Manager's assessment of the market environment as of March 2011, should not be considered a recommendation to buy, hold or sell any security and should not be relied on as research or investment advice. All information provided herein is subject to change without notice. Macquarie Allegiance Capital (MAC) has used third party sources it deems as reliable, however MAC cannot guarantee their accuracy.

Macquarie Allegiance Capital, LLC is not an authorized deposit-taking institution for the purposes of the Banking Act (Cth) 1959, and MAC obligations do not represent deposits or other liabilities of Macquarie Bank Limited ABN 46 008 583 542. Macquarie Bank Limited does not guarantee or otherwise provide assurance in respect to the obligations of MAC.

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

☎ Macquarie Allegiance Client Services
213-233-4500

@ MFGClientServicesLA@Macquarie.com

▶ www.MacquarieAllegiance.com

Delaware Investment Client Service
877-693-3546

www.DelawareInvestments.com