# INVESTMENT PERSPECTIVE

For the quarter ended June 30, 2010, the Barclays Capital Intermediate Government/Credit Index (BCIGCI) returned +2.97%. U.S. Treasuries (+4.68%) posted positive returns in the June quarter as rates declined in a flight to quality. Long Treasuries (+12.17%) outperformed intermediate Treasuries (+3.57%) by 860 basis points as the yield curve shifted in a bull flattening fashion. The thirty-year Treasury reached its lowest level (3.89%) since April 2009 and the two-year Treasury reached an all time low of 0.60%.

Mortgage-backed securities (+2.87%) performed in line with duration-matched Treasuries during the June quarter. The OAS of the Barclays Capital U.S. Mortgage Backed Securities Index tightened 9 basis points (from 20 to 11 basis points) as investors anticipated slower prepayment speeds in response to tighter underwriting standards and lower home prices that limit refinancing despite record low mortgage rates.

Corporate bonds (+3.27%) underperformed duration matched Treasuries by 223 basis points in the June quarter as the OAS of the Barclays Capital U.S. Credit Index widened 43 basis points, from 136 to 179 basis points. Long corporates (+5.93%) outperformed intermediate corporates (+2.41%) by 352 basis points, benefitting from lower long-term Treasury yields. On a duration-adjusted basis, intermediate corporates outperformed long corporates by 351 basis points of excess return.

We appear to be in a soft patch in what we believe is a moderate economic recovery led by improving final demand, a sharp inventory correction, and an improved outlook for business spending supported by increased profitability and a strengthening U.S. dollar, along with accommodative monetary and fiscal policies. The recovery is fragile and is somewhat less robust in an historical context. Consumer spending may be impacted by continuing challenges in the housing market, increased market volatility, and near-term declines in the equity market, as well as a gradual recovery in the labor market. Final demand may also be adversely affected by a higher savings rate and less access to credit. The impact of government austerity measures, including a combination of higher taxation and lower spending, represents a key risk factor to global economic growth in the near-term.

During the first quarter of 2010, the U.S. economy expanded 2.7%, supported by strengthened consumer spending (3%), along with the sharpest year-over-year corporate profit gains (34%) in more than a quarter century. Inventory restocking accounted for 1.9% of economic growth as the level of inventories rose for the first time since March 2008. Growth was adversely impacted by declines in residential construction (-10%) and the sharpest decline in local government spending since 1981.

In June 9th testimony before Congress, Federal Reserve Chairman Ben Bernanke stated, "Consumer spending is likely to increase at a moderate pace going forward, supported by a gradual pickup in employment and income, greater consumer confidence, and some improvement in credit conditions." Following the loss of over eight million jobs throughout the recession, the U.S. economy has created nearly 900 thousand new jobs through the first half of 2010, with nearly 600 thousand coming from the private sector, and the unemployment rate has declined from 10% to 9.5% over the same horizon reflecting a gradual recovery in the labor market.

Following the expiration of the homebuyer tax credit on April 30th, pending sales of homes saw their biggest drop on record (-30%) in May, indicating that residential spending may continue to be a drag on the economic recovery. Purchases of new homes dropped in May at the fastest pace (-33%) and to the lowest level on record. In the meantime, an expected pipeline of foreclosures threatens to increase the inventory of existing homes for sale from an already elevated level (8.3 months) that may put further pressure on home prices.

Notwithstanding stronger final demand and increased business spending, significant slack persists in the U.S. economy, dampening inflationary pressures. May marked the second consecutive month of declines in consumer prices, with year-over-year prices rising a modest 2%. Housing accounts for more than 40% of CPI and the aforementioned challenges facing the residential market suggest a benign near-term outlook for inflation.

Following the two day meeting of the Federal Open Market Committee (FOMC) that concluded on June 23rd, the Federal Reserve kept its targeted range for the fed funds rate at 0 - ¼% and reiterated the expectation that the benchmark lending rate will remain "exceptionally low… for an extended period." The targeted range has remained unchanged for eighteen months and the Fed cautioned that "financial conditions have become less supportive of economic growth on balance, largely reflecting developments abroad."

On June 30th, the Congressional Budget Office (CBO) released its Long-Term Budget Outlook, describing the outlook as "daunting," as its projections "provide a clear indication of the serious nature of the fiscal challenge facing the nation." According to the CBO, the projections "would reduce national saving, leading to higher interest rates, more borrowing from abroad, and less domestic investment—which in turn would lower income growth…. would also reduce lawmakers' ability to respond to economic downturns and other challenges… (and) would increase the probability of a fiscal crisis." In our view, the "unsustainable" path of growth in debt suggests we are in the early stages of a secular rising interest rate environment led by higher Treasury yields.

As part of its annual report (released 6/28), the Bank for International Settlements (BIS) emphasized key risks for "renewed financial volatility, market disruptions and funding stress." According to the BIS, "the first and most immediate challenge is to make a convincing start on reducing budget deficits in the advantaged economies." The BIS also argued that central banks should reduce their support of private financial institutions, noting "if such support is maintained for too long, it will create moral hazard, undermine private sector financial intermediation and generate new, hidden risks."  Financial regulatory reform may be the first step toward such action.

On June 30th, the U.S. House of Representatives passed the Dodd-Frank Wall Street Reform and Consumer Protection Act.  The reform focuses on reducing systemic risk and ending "too big to fail" through a new oversight council, expanded resolution authority for the FDIC, and the elimination of individual company bailouts.  From a credit perspective, we believe any final legislation will reduce risk through initiatives such as limitations on proprietary trading, regulation of OTC derivatives, and the elimination of TruPs (trust preferred securities) from Tier 1 capital. In our view, financial regulatory reform will prove to be positive for debtholders as it strengthens overall creditworthiness of financial institutions.  In conjunction with our expectations that we are in the early stages of a secular rising interest rate environment, we believe corporate bonds offer the best relative value within the investment grade universe of fixed income securities.