

FIXED INCOME MARKET UPDATE
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FIXED INCOME MARKET UPDATE

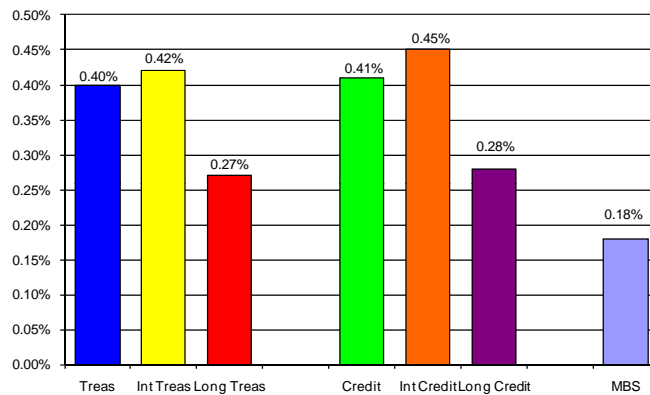
- For the month ended February 28, 2010, the Barclays Capital Aggregate Bond Index (BCAGG) returned +0.37%.
- U.S. Treasuries (+0.40%) posted positive returns as the yield curve steepened modestly. In this environment, intermediate Treasuries (+0.42%) outperformed long Treasuries (+0.27%) by 15 basis points. The 2/10 curve reached its steepest level on record during February as the FOMC reiterated its commitment to keep rates low for “an extended period” and concerns relating to European sovereign debt and budget problems led to a flight to quality in shorter maturity Treasuries.
- Mortgage-backed securities (+0.18%) underperformed duration matched Treasuries by 7 basis points in February. The OAS of the Barclays Capital U.S. Mortgage index widened 12 basis points to 28 as the market discounted the end of the Federal Reserve’s MBS purchase program on March 31. In the near term, mortgage-backed securities may be supported by increased demand following a sharp rise in prepayments associated with Fannie Mae and Freddie Mac’s decision to purchase delinquent loans from existing pools and bring the loans on balance sheet.

FIXED INCOME MARKET UPDATE (continued)

- Corporate bonds (+0.41%) modestly outperformed duration-matched Treasuries due to the carry advantage of credit, as the OAS of the Barclays Capital U.S. Index widened by 2 basis points from the previous month to close at 158. In conjunction with the move in Treasury yields, intermediate credit (+0.45%) outperformed long credit (+0.28%) by 17 basis points.
- Industrials (+0.48%) were the best performing credit subsector on an absolute and duration-adjusted basis in February. Industrials, the only subsector to realize positive duration-adjusted returns in February, outperformed utilities (+0.38%) and financials (+0.17%) by 10 and 33 basis points of excess return, respectively.
- During the month, lower quality investment grade securities outperformed. BBB rated securities were the best performing quality subsector. BBB's outperformed A, AA and AAA rated securities by 34, 3 and 6 basis points of excess return, respectively.

SECTOR, QUALITY & TERM STRUCTURE RETURNS FOR THE MONTH ENDED FEBRUARY 28, 2010

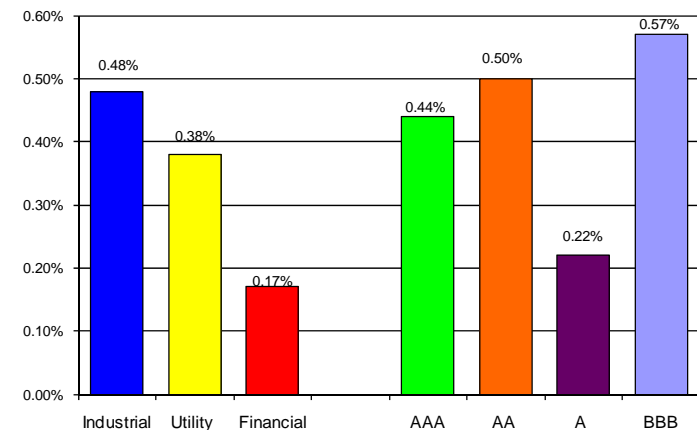
U.S. Fixed Income Sector and Term Structure Returns



Longer dated securities outperformed as the yield curve steepened. Mortgages underperformed as the market anticipates the end of the Fed's purchase program.

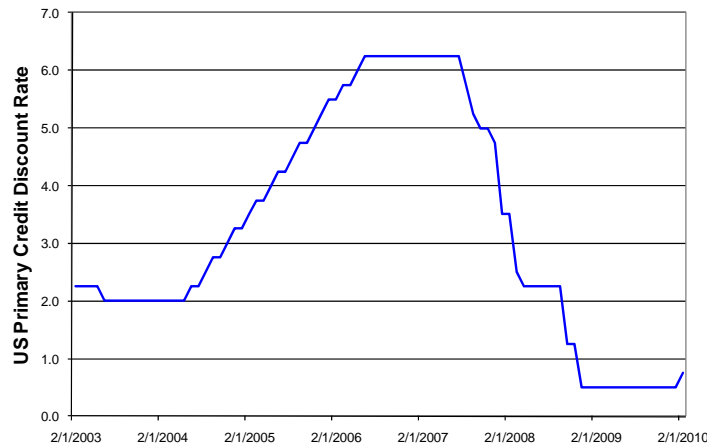
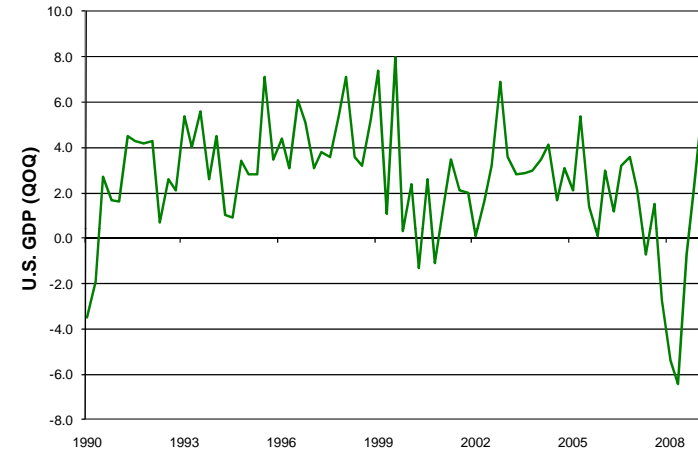
Industrials were the best performing credit subsector. BBB rated securities outperformed despite a longer duration profile.

U.S. Credit Subsector and Quality Returns



UPDATE ON THE U.S. ECONOMY

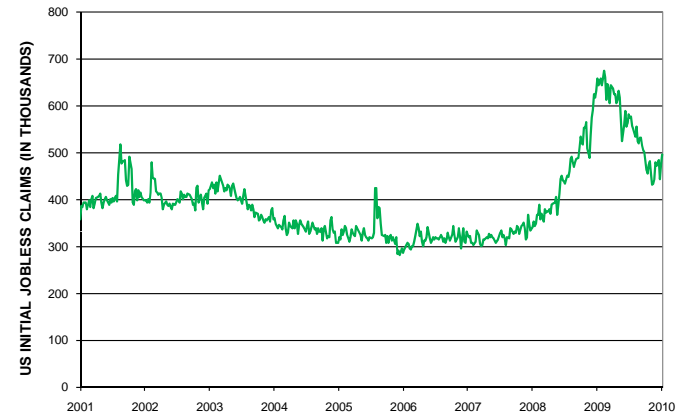
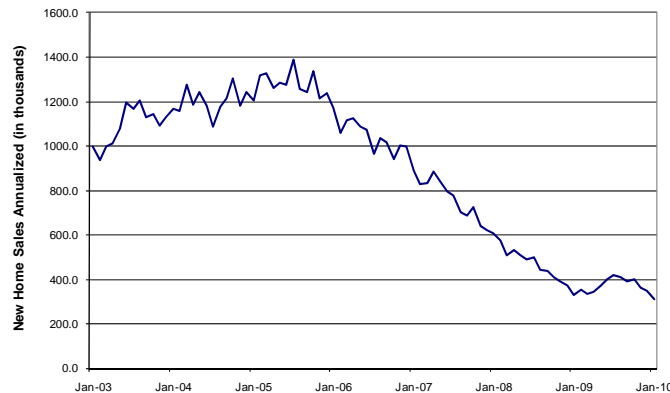
During the fourth quarter of 2009, the U.S. economy expanded 5.9% (annualized). This represents the best quarterly performance since 2003, buoyed by a 6.5% increase in business spending including an 18.2% increase in equipment and software spending. Growth in final demand has been somewhat restrained as businesses continue to better align inventories with sales. Still, the change in inventories added 3.9% to GDP as “firms reduced the pace of inventory liquidation markedly.”



On February 18, the Federal Reserve increased the discount rate by 25 basis points, to 0.75%, and shortened the term of discount window lending back to overnight from 28 days “as a further normalization of... lending facilities.” The Fed noted the actions taken “do not signal any change in the outlook for the economy or for monetary policy.”

UPDATE ON THE U.S. ECONOMY (continued)

Consumer spending rose a modest 1.7% during the fourth quarter as a weak labor market is impacting sales. In his February 24th testimony before Congress in conjunction with the release of the semiannual *Monetary Policy Report to the Congress*, Federal Reserve Chairman Ben Bernanke stated that “deterioration in the labor market is abating.” In January, the unemployment rate dropped to 9.7% at the same time the participation rate increased, suggesting conditions may be starting to turn. More recently, however, initial jobless claims turned higher and continuing claims data suggests jobs remain difficult to find. Dr. Bernanke went on to say, “the job market remains quite weak... and job openings (are) scarce,” citing “the increasing incidence of long-term unemployment.”



Following fourteen consecutive quarters of declines in residential spending, housing has now expanded for two consecutive quarters. Still residential spending has decelerated somewhat, rising 5% in the fourth quarter versus 19% in the prior quarter. Chairman Bernanke noted, “starts of single-family homes, which rose noticeably this past spring, have recently been roughly flat, and commercial construction is declining sharply, reflecting poor fundamentals and continued difficulty in obtaining financing.” In January, new home sales dropped 11% to the lowest level on record and existing home sales declined 7.2% as a weak job market more than offset the extension and expansion of government tax credits designed to support the housing market.

THE AFTERMATH OF THE CREDIT CRISIS: THE FEDERAL RESERVE EXIT STRATEGY

Extensive liquidity provisions have been closed or have been winding down, with completion expected by June 30, 2010 as the Fed deems circumstances are no longer “unusual and exigent.”

Policy accommodation will be removed ahead of any change in the fed funds rate

- “The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period.”
- FOMC Statement, January 27, 2010

Interest rate paid on reserves will likely move higher to effect more restrictive monetary policy

- “By increasing the interest rate on reserves, the Federal Reserve will be able to put significant upward pressure on all short-term interest rates... it is possible that the Federal Reserve could for a time use the interest rate paid on reserves, in combination with targets for reserve quantities, as a guide to its policy stance.”
- Statement by Dr. Ben Bernanke, February 10, 2010

Massive purchase program is also nearing an end, but large outright sales are unlikely

- “A range of evidence suggests that these purchases and the associated creation of bank reserves have helped improve conditions in private credit markets and put downward pressure on longer-term private borrowing rates and spreads.”
- Statement by Dr. Ben Bernanke, February 10, 2010
- Reverse repurchase agreements and term deposits for depository institutions are the preferred tools to reduce reserves.

ECONOMIC AND MARKET OUTLOOK

- In its semiannual *Monetary Policy Report to the Congress*, the Federal Reserve noted that accommodative monetary and fiscal policies and the coincident improvement in financial conditions “along with increased business and household confidence, appear likely to boost spending and sustain the economic expansion.” According to the Fed, the U.S. economy is expected to expand between 2.8%-3.5% in 2010 reflecting a tempered pace of recovery resulting from “households’ desire to rebuild wealth, still-tight credit conditions facing some borrowers, and, despite some tentative signs of stabilization, continued weakness in labor markets.” The FDIC’s Quarterly Banking Profile (released 2/23) accentuated the difficulties some borrowers may face in obtaining credit as the FDIC’s “problem list” of banks jumped above 700 for the first time since 1993. In 2010, the FDIC expects bank failures to exceed 2009’s level (140 banks, the worst since 1992) at the very same time its Deposit Insurance Fund (DIF) remains negative.
- According to the FDIC, more than 5% of total loans in the banking system are noncurrent as “asset quality continued to deteriorate.” Many of the challenges within the banking sector are the same as those faced by Fannie Mae and Freddie Mac, the government-sponsored entities (GSEs) under FHFA conservatorship. On February 10, both GSEs announced plans to purchase delinquent loans with an aggregate value of approximately \$200 billion from mortgage-backed securities that the companies guarantee and keep the loans on their respective balance sheets. These transactions should result in a sharp rise in prepayments for mortgage-backed securities investors at the very same time such securities are trading significantly above par as the Federal Reserve nears the completion of its massive \$1.25 trillion purchase program. We believe the actions of Fannie Mae and Freddie Mac underscore the risks investors face as spreads in mortgage-backed securities remain near all-time tights.
- In our view, the increase in the discount rate has little direct impact on monetary policy in the near term but signals a shift toward a more restrictive stance over time. Investors focused on the targeted fed funds rate to define monetary policy will miss a significant portion of the upcoming tightening as the Fed will likely utilize a series of unconventional tools to unwind its balance sheet. As the liquidity provisions and securities’ purchases expire, the Fed will likely increase the interest rate paid to depository institutions for reserves in an effort to put “significant upward pressure on all short-term interest rates.” This action will likely be utilized in conjunction with other tools such as reverse repos designed to offset the increase in reserves. The Fed has also announced plans to introduce term deposits for banks “which are roughly analogous to certificates of deposit” to drain reserves. These initiatives are largely untested and represent key risk factors to the Fed’s ambitious exit strategy.