MARKET Commentary

"Unusually Uncertain"

-Federal Reserve Chairman Ben Bernanke on the US economic outlook, July 21, 2010

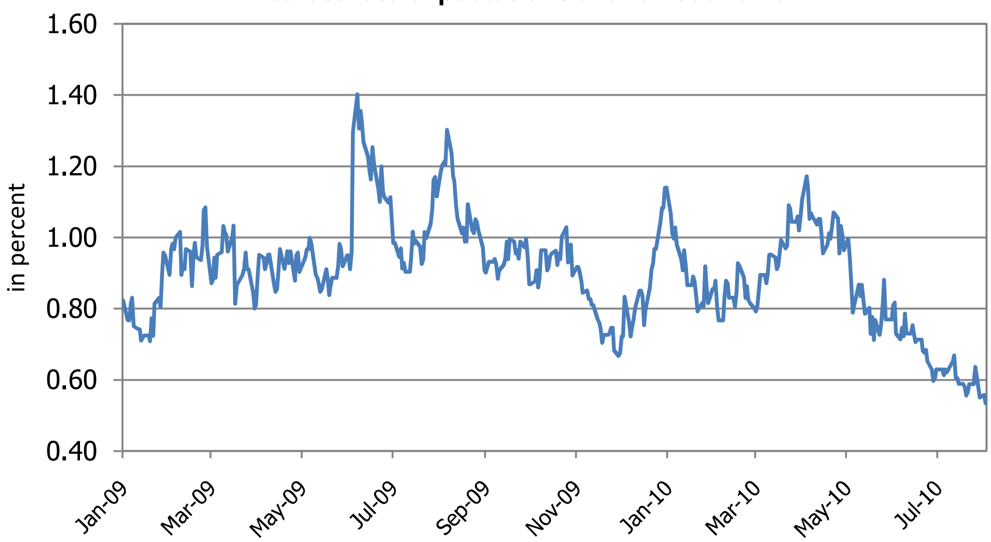
August 2010

It has been over a year and a half since the FOMC lowered the Fed Funds Target Rate to a range of 0-25 basis points. Despite consistent guidance from Chairman Ben Bernanke that this low rate environment will persist for an "extended period," we are amazed with the number of short-duration investors who choose to position portfolios against an unexpected, dramatic rise in interest rates. This strategy not only protects against what, in our view, is highly improbable, but it does so to the detriment of portfolio yield and income generation. With short interest rates likely to remain range-bound at these low levels for the next 12-18 months, we recommend that investors consider extending a portion of their ultra-short portfolio further out the curve in high-grade securities to take advantage of marginally higher rates and the beneficial effects of curve roll-down.

How Long Will We Have to Endure?

We retain our outlook that the FOMC will not raise the Fed Funds Target Rate until 2H 2011 at the earliest. Short-duration investors must come to grips with the fact that money market rates will remain extremely low. Money market yields and interest rate expectations have continued to decline as investors have become increasingly concerned over the strength and durability of the economic recovery. As evidence, the yield on the 2-year Treasury note, a leading indicator of short-term interest rates, hit an all-time low of 54.61 basis points on July 30, 2010.

Figure 1: The 2-year Treasury note continues to set new lows as interest rate expectations are revised lower



Source: Bloomberg

Our interest rate forecast is in line with the majority of Wall Street analysts, which have tempered overly optimistic estimates in recent weeks—a trend we expect to

US Treasuries

As of 31-Jul

Benchmark	Yield
3 Month	0.15%
6 Month	0.20%
1 Year	0.28%
2 Year	0.55%
5 Year	1.60%
10 Year	2.91%
30 Year	4.00%

Merrill Lynch Indexes

30-Jun to 31-Jul

Index	Return
1-3 Yr Gov/Corp ≥ A	0.37%
1-3 Yr Municipals	0.43%
1-3 Yr Agencies	0.27%
0-3 Month UST	0.02%
S&P 500	7.01%

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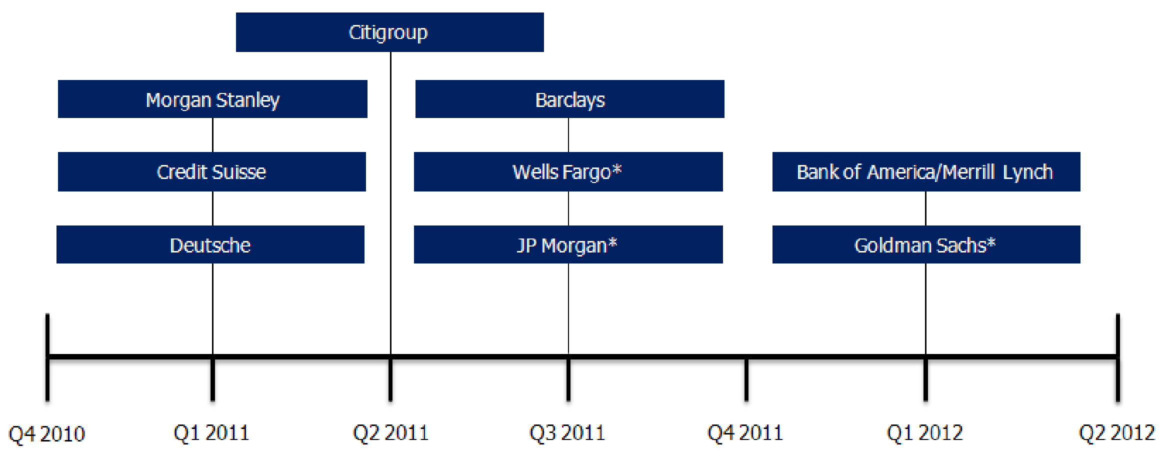
Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan continue. The most pessimistic of the large banks, Bank of America/Merrill Lynch, has predicted that the first rate action will occur in March 2012. If the Bank of America/Merrill Lynch forecast proves true, this means we have just barely reached the halfway point in our journey of exceptionally low rates.

Investors who have not yet positioned investment portfolios for this extended period of low rates (i.e., have remained ultra short or all in money funds) have a seemingly difficult decision to make. Extending a portfolio in a low rate environment can be challenging psychologically, especially when the added benefit is measured in mere basis points. An important factor to consider, however, is not only the current shape of the yield curve, but the likely shape going forward.

Figure 2: Expectation for FOMC rate action by the major bulge bracket banks



** Earliest estimated date, according to most recent reports* *Source: Broker Research Reports and Bloomberg*

In recent weeks, there have been increased calls for the 2-year note to hit 40 basis points. While it is almost hard to believe short yields could continue to push lower, the bias is clearly for lower rates and investors need to be conscious of how lower rates will affect portfolio yield and interest income.

Money Funds Capitulate

One industry that seems to be capitulating under the pressure of extended low rates is the money market fund industry. With little to no income being generated from many funds in the various fund families, sponsors have chosen to close unprofitable funds as chronically low interest rates have resulted in fees being waived for much longer than anticipated. A significant decrease in revenue from waived management fees has created an interesting risk management issue for many fund sponsors.

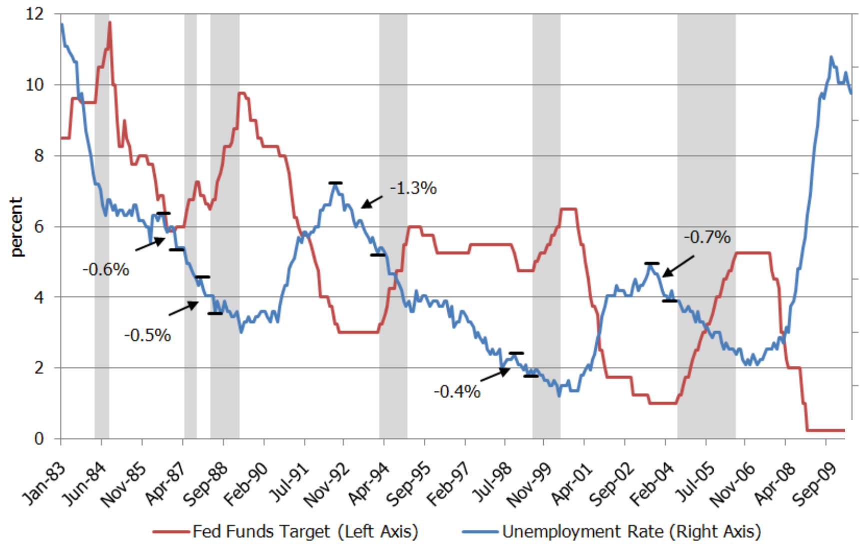
One of the main risks that a fund sponsor assumes is supporting the stable NAV in the case of an adverse credit event—i.e., a default on a position in the fund. This risk was realized with the bankruptcy of Lehman Brothers, and several sponsors were forced to provide capital to buy impaired positions at par. In an environment where money funds are looking to increasingly riskier credits to buoy historically low fund yields, this risk is amplified.

Without an adequate return to compensate for this heightened risk, it is becoming difficult for fund sponsors to justify taking on such credit risks. These two effects combined, low revenue generation and increased credit risk, have caused many fund sponsors, especially sponsors without a strong capital base, to reconsider the viability of this business unit going forward.

Further Economic Weakness

In his testimony in front of the Senate Banking Committee last week, Chairman Bernanke used the peculiar term "unusually uncertain" in assessing the future of the economic recovery. Chairman Bernanke's unique choice of words reflects the precarious situation the Federal Reserve finds itself in diagnosing and designing policy action to address the conflicting risks of low growth, deflation and elevated inflation in the long run.

Figure 3: Unemployment remains stubbornly high, and must improve before the FOMC moves on interest rates



Source: Bloomberg

Economic indicators have signaled that the pace of growth has softened in Q2 2010, with GDP recording a 2.4% annualized growth rate. This is off from the blistering pace set in Q4 2009 of 5%, and 3.7% recorded in Q1 2010. Elevated unemployment continues to act as a drag on the recovery, and in his testimony Chairman Bernanke indicated that unemployment will likely remain above 7% until 2012. The ripples from stubbornly high unemployment have been felt in recent retail sales, manufacturing, housing and consumer confidence data which have underwhelmed the market.

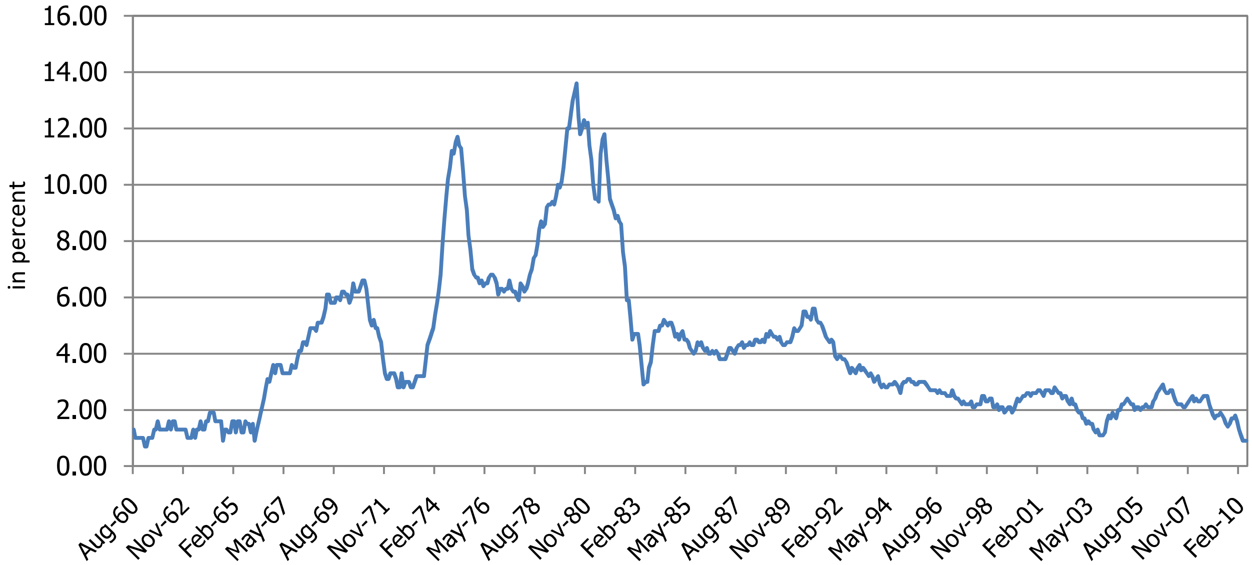
Near-Term Risks Point to Deflation, Not Inflation

One of the many economic statistics we follow to gauge the health of the economy is the general level of prices—and it is not rising prices that currently worry us. Despite the unprecedented amount of monetary stimulus that has been injected into the system, recent data has shown that prices have continued to contract. Year-over-year core inflation has hit a 44-year low of 0.9%. Month-over-month inflation as measured by CPI has declined three months in a row.

Deflation and its close relative disinflation—a decrease in the level of inflation—concern us for a few reasons. First, falling prices cut into business profits and may result in further economic contraction as investment and purchases are delayed. This cycle of economic weakness and falling prices can build upon itself and may lead to what economist call a deflationary spiral. Depending on the environment leading up to a crisis, a deflationary spiral can be sharp and brief as occurred in the Great Depression, or gradual and prolonged like Japan in the 1990s.

Second, deflationary pressure intensifies the burden of existing debt. Economic weakness and falling prices increase the real value of cash and inflate the cost of existing debt. As inflation expectations decline, in some cases turning negative, the real cost of servicing and retiring debt becomes increasingly difficult. This problem is amplified following a period in which a large amount of credit has been extended and remains outstanding.

Figure 4: Core CPI has hit 44-year lows on concerns surrounding the economic recovery



Source: Bloomberg

Lastly, the policy tools that the Federal Reserve has to combat a potential deflationary threat have been reduced as significant resources have already been deployed during the current economic crisis. The Federal Reserve has seemingly thrown everything but the "kitchen sink" to prevent the great recession from turning into the next great depression. Several analysts are becoming concerned that the Federal Reserve may have already run out of viable options if current conditions deteriorate further. While the Federal Reserve certainly has several options still available, the efficacy of further policy action will largely depend on the market's reaction to policy changes and the pace of economic contraction if it were to occur.

A Student of History

The last thing that the Federal Reserve wants is for deflation to take hold. As a student of the Great Depression, Chairman Bernanke knows this better than anyone else. Critical miscues by the Federal Reserve, policy makers and regulators led to a severe contraction in the money supply at the very time that accommodative policy was desperately needed to promote growth.

In 2002, following the aftermath of the dot-com bubble, Chairman Bernanke gave a now-famous speech that outlined the risks of deflation and the policy tools the Fed has to address them. The title of the speech, "Deflation: Making Sure 'It' Doesn't Happen Here," exemplified Chairman Bernanke's commitment to avoid deflation at all costs, and the speech is now viewed as the blueprint that the Fed would follow if deflation were to take hold.

The main point of Chairman Bernanke's speech is that deflationary pressures must be fought with aggressive monetary stimulus. It is safe to say that the Federal Reserve will do everything in its power to prevent deflation from occurring again. With prices posting steady declines over recent months this furthers the argument of persistent low rates for the foreseeable future. As a result, short-duration investors should consider extending portfolio duration focusing on high-grade securities like Treasuries, Agencies, FDIC-guaranteed TLGP paper, and strong industrial credits.

Extension Trade

Spreads may not be at their most attractive levels, but we still feel that there is value in extending—even in the money market space. As we have mentioned previously, our motivation is mainly driven by our outlook for interest rates. Spreads look relatively more attractive as you go further out the curve, with the spread for 1-year TLGP paper yielding 12.5 basis points over Treasuries. A strategy that many clients have undertaken in the current environment is buying 1-2 year paper and riding the curve, selling securities as they roll into the flatter part (0-3 months) of the curve. In an environment where interest rates have continued to fall, this has proven to be a very profitable trade.

Figure 5: With short-term rates remaining low, we still see value in the long-end of the money market curve

Sector	1 Month	3 Month	6 Month	12 Month
Treasuries	0.135	0.135	0.185	0.245
Agency Discount Note	0.160	0.190	0.240	0.350
TLGP	-	-	0.260	0.370

Source: Bloomberg and Dealer Runs

Looking Forward

We continue to expect the economy to face headwinds which could result in several near- and long-term risks to growth. While the recent precipitous decline in interest rates has been discouraging from an investing standpoint, we are preparing our clients and client portfolios for the prospect that yields go lower—which we think is very likely.

We continue to closely monitor the Obama administration's efforts at passing new broad-based legislation. Of the big issues remaining, we expect that the expiring tax cuts will likely to receive the most attention in the coming months. This will draw particular interest from the market as Congress will have to balance the mounting budget deficit while still promoting investment and growth.

Please feel free to call the desk with questions.

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