FIXED INCOME STRATEGY HIGHLIGHTS … APRIL, 2009

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"THE TRUE TEST OF THE AMERICAN IDEAL IS WHETHER WE"RE ABLE TO RECOGNIZE OUR FAILINGS AND THEN RISE TOGETHER TO MEET THE CHALLENGES OF OUR TIME. WHETHER WE ALLOW OURSELVES TO BE SHAPED BY EVENTS AND HISTORY, OR WHETHER WE ACT TO SHAPE THEM."

President Barack Obama (1955–present)

General Observations

As always we are looking out for contrary indicators in the economic statistics and it would appear that some of the indicators have turned less negative in the past couple of months. For example the ISM manufacturing index has turned up almost 3 points from a near 30 year low in December, the non manufacturing composite advanced more than 5 points in January over November's trough, and Morgan Stanley's business Conditions Index rose by ten points in February from the depths of last autumn. The composite of leading economic indicators (LEI) has risen two months in a row. It is our view that this data suggests that the intensity of the declines is beginning to fade, and with fiscal stimulus in the pipeline, recovery is likely to emerge by year end. Remember this improvement is coming off some of the deepest declines we have seen in decades and investors will certainly be wary of the volatility in this type of conflicting data especially after the precipitous declines we have experienced in the past few months. We remain cautiously optimistic recognizing that we still have a number of policy actions still to be implemented in the face of stiff financial and economic headwinds.

The Economic Outlook – Are we at an Inflection Point or does it Really Get Worse?

- **The final economic statistics for 2008 showed that the economy grew at 1.3% as measured by real GDP, which compared to 2.0% in 2007.** Consumption (70% of the economy) grew 0.3% versus 2.8% in 2007 with private domestic investment falling 5.9% compared to a decline of 5.4% in 2007. Residential investment fell 20.8% compared to a fall of 17.9% in 2007. Equipment and software spending, a measure of capital investment, fell 2.9% versus an advance of 1.7% in 2007. Exports increased by 6.5% whereas imports fell by 3.3%. This change in the trade balance has strengthened the U.S. dollar while damaging the export economic model of the Asian economies. The government sector of the economy increased by 2.9% versus 2.1% in 2007. Federal spending advanced 6.0% with state and local government increasing by 1.2%. In terms of the contribution to GDP growth, consumption added 0.2%, investment subtracted 0.9%, while net exports added 1.4% and government added 0.6%.

- **Unfortunately the fourth quarter performance of the economy was not as sanguine.** Real GDP fell 3.8% and, after adjustment for inventory changes, actually declined 5.1% in the fourth quarter. Consumption declined 3.5% with private investment falling 12.3%. Non residential spending which had earlier been the bulwark of the economy fell 19.1%. Exports which had supported the economy in 2007 fell by 19.7% with imports falling 15.7%. Government spending grew 1.9%, with federal spending up 5.8% and state and local expenditures declining by 0.5%. The contributions to the decline in the growth of GDP in the fourth quarter were consumption (-2.5%), private investment (-1.8%), net exports (+0.1%) and government expenditures (+0.4%). The economy declined by 0.5% in the third quarter.

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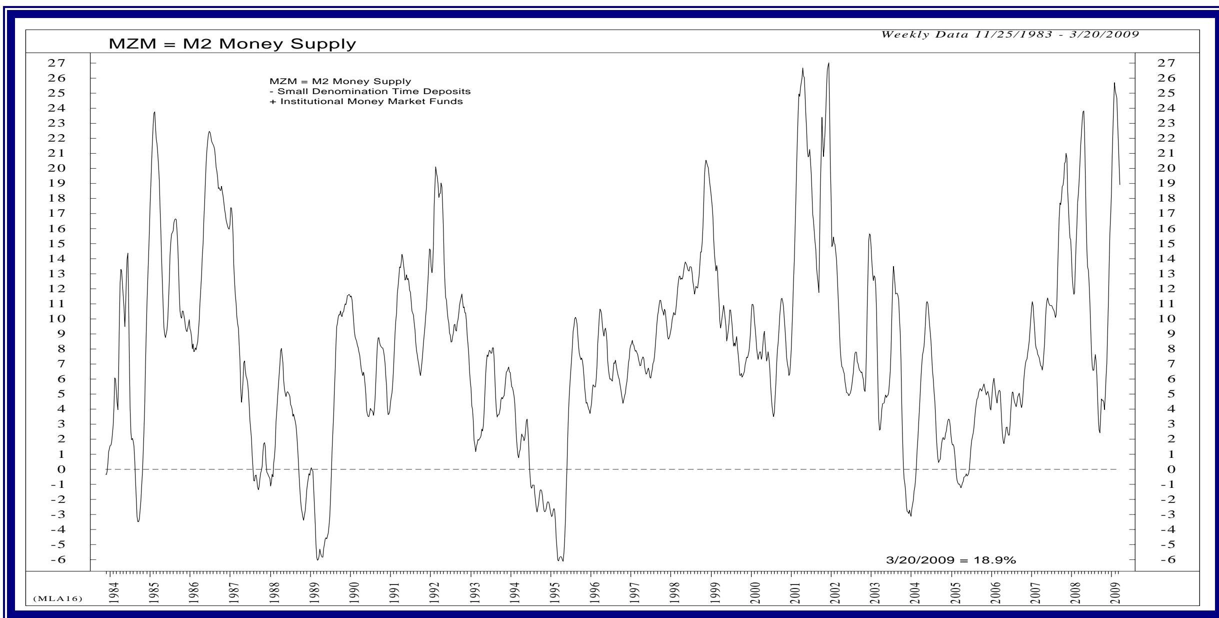
- **The y/y decline in U.S. nominal GDP is very rare, and has typically been followed by sharp snap-backs.** In a more global economy, the domestic snap-back may not be as sharp – given the cushion from trade we saw in the U.S. data in 1Q, a return to growth should also help boost foreign economies through U.S. imports. The increase in March industrial production in Japan (+1.6% m/m), for instance, suggests a "V" shaped economic recovery is possible abroad, at least in the short term. And there are certainly other improved manufacturing readings globally, including the China PMI increasing to 53.5% in April. However, like in the U.S., the question of sustainability remains – especially with economic uncertainty remaining in key cyclical sectors: housing (too much supply), autos (bankruptcy), and capex (still depressed business confidence).

- **Investors remained concerned with future growth of the $14.3 trillion U.S. economy.** Most current economic statistics released by the government are still weak and are more than highlighted by the news media. The unemployment rate is now running at 7.6% with 3.6 million jobs lost since January 2007. Capacity utilization in January is down below 72% with industrial production falling 7.85%. December durable goods orders are down 20.2% from a year ago levels. The Treasury reported an $83.5 billion deficit in January bringing the fourth-month total for fiscal 2009 to $569 billion. Our expectation for the fiscal year is $1.5 trillion. A major concern is the financing of the U.S. fiscal deficit given its size and the effect it might have on the currently low interest rates on the Treasury debt. The housing data with regards to starts (only 550,000 in December), prices (existing homes at the median price of $174,000) and new home sales at only 330,000 in December suggest that the low point has not yet been reached. On a brighter note, existing homes sales rose 6.5% in December reducing the inventory level to 9.3 months from 11.2.

EXHIBIT I



Source: Ned Davis Research

- **There is little question that the Chrysler bankruptcy is an event that we would rather not see during a severe recession – additional job loss at this juncture can do little but raise fears of a negative feedback loop.** But given that credit concerns in 4Q have already devastated U.S. vehicle production, the market now appears to be (appropriately) treating this issue as a non-event. The bet in the market appears to be that the government -- which has stakes in both the autos and the banks -- will not let the situation get too out of hand, despite the fact that vehicle sales registered just a 9.3 million SAAR in April.

- **The U.S. manufacturing PMI was also weak in April, but "less bad" as it moved up to 40.1% versus 36.3% in March (above 50% is the breakeven mark).** Initial claims also improved slightly, declining -14,000 to 631,000 last week, pulling the 4 week average down to 637,000. There was still plenty of weak data in this report, as the level of initial claims remained elevated, and continuing claims continued to trend higher in the prior week (over 6 million). But evidence of stability in initial claims is certainly a first step at this point.

- **Although we have probably seen the peak in claims, the effects of a weak labor market will most probably linger for a while –** the Employment Cost index just reported an increase of just 0.3% quarter to quarter placing continued downward pressure on wages and compensation. Despite this wage pressure, however, consumer confidence still appears to be improving from depressed levels. The Conference Board monthly survey of consumer confidence was better-than-expected in April, rising to 39.2 on a small increase in the present situation component, and a large increase in consumer expectations. Additionally, the University of Michigan Survey rose further to 65.1 in the second April reading, suggesting the month ended on a solid note. While we are not seeing increases in lower paying jobs, at least the percentage of higher paying jobs declined slightly in April to 47.9% versus 48.8% the prior month. The ABC weekly measure of consumer confidence also continued to tick higher last week to -45, and the Rasmussen measure has trended up as well.

- **As consumer confidence forms a base and a number of the Federal programs start working, the real GDP decline of -6.1% quarter to quarter just announced will most probably be old news.** The second-derivative of growth appears to have improved considerably as we have moved past the economic shocks of last year, and have an improved outlook for government spending (which subtracted from first quarter 2009 growth) given the push for fiscal stimulus.

- **The FOMC certainly left their options open in terms of the timing and amount of their interventions into the markets, in addition to again pledging that the fed funds rate is likely to stay low for an "extended period".** The reaction of the bond market, as 10-yr yields rose w/w to 3.15% at the end of the last week in April, however, suggests that worry is building about the quantity of government debt coming to the market (due to fiscal stimulus), if the Fed is not going to step up as a buyer of last resort. Nonetheless, mortgage rates have remained low, and the Fed seems satisfied with their policies for now.

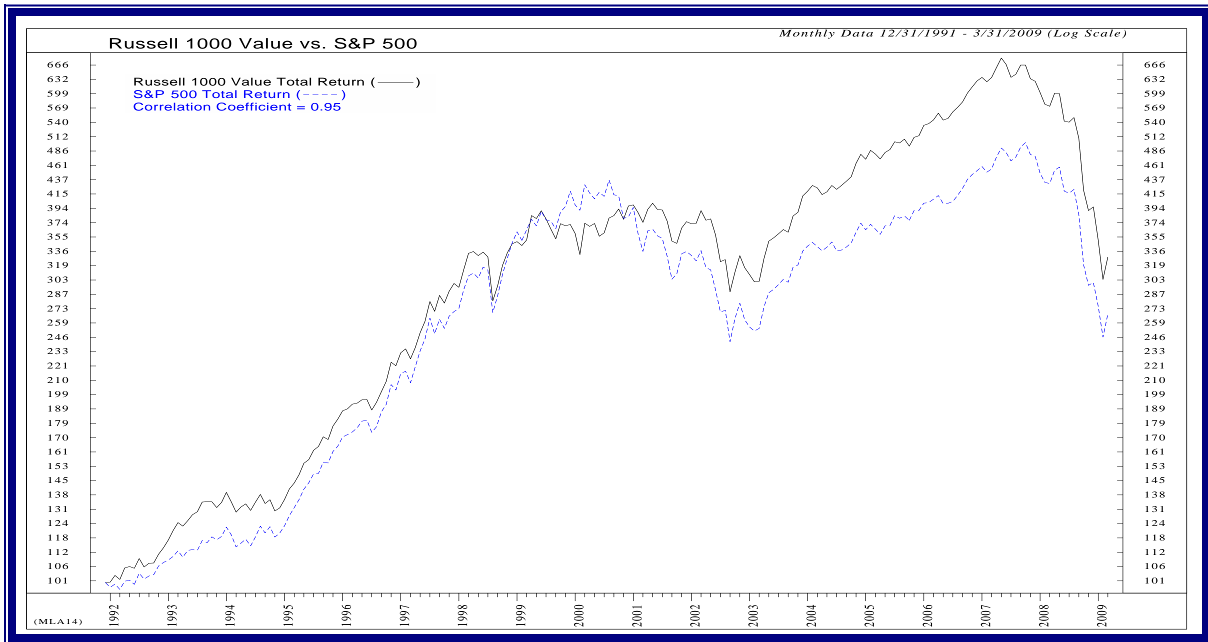
- **The case for continued low mortgage rates for an extended period is certainly not hard to make.** The Case-Shiller home price index indicated that prices continued to decline through February. The fall in home construction, which has subtracted from GDP, should eventually help bring the housing market into equilibrium, but for now vacancy rates remain elevated, including the rental vacancy rate which should continue to exert downward pressure on rents. Rent, typically being set by a contract, is generally a lagging indicator. While the homeownership rate has come down some, correcting from a level that was probably "too high", government policies are probably attempting to stretch out the adjustment; with the housing market flattening out, it seems less likely for it to function as a driver of nominal GDP as it has in the past.

- **With home prices and stock prices still down considerably, consumer assets have taken a significant hit, yet debt service has remained elevated.** The current Fed and Treasury plans to lower mortgage rates have boosted refinancing, though that play lost a little steam last week as refinancing applications declined -21.9% week to week. The government's recent action appears to be aimed at slowing down the pace of economic deleveraging. Chairman Bernanke recently indicated that the "financial system has stabilized and is able to provide the necessary credit on the scale our growing economy requires".

- **It would appear that a case can be made for an inverse correlation between consumer net worth as a share of income (which has declined sharply), and the saving rate (which has started to increase).** Last week's personal income report showed a saving rate of 4.2% in March, which is up from a year ago, but has been roughly constant over the past four months. We continue to believe that a much-higher consumer saving story is likely to play out over a much longer time frame. In the 1930s, for instance, consumers may have wanted to save more, but it took the income and rationing from WWII to allow them to sharply increase their saving.

❖ **On a positive note, productivity at 2.7% in the fourth quarter suggested that corporations are running their operations quite efficiently.** The savings rate at 3.6% in December has been the necessary adjustment after years of overspending by consumers. Because inflation is under control (the CPI is virtually zero over the twelve months through January), real hourly earnings are in fact growing at 4.5%. While the leading indicators are down 3.4% year-over-year in December, the last two months have improved because of the huge increase in money supply. The combination of expansive fiscal policy, namely the $787 billion recently voted by Congress and the zero interest rate policy by the Federal Reserve, including a policy of quantitative easing, should ultimately revive the economy. Our view after the first quarter GDP decline of 6.1% suggests we will see another decline of 3.0% in the second quarter, followed by a recovery in the next two quarters.

EXHIBIT II



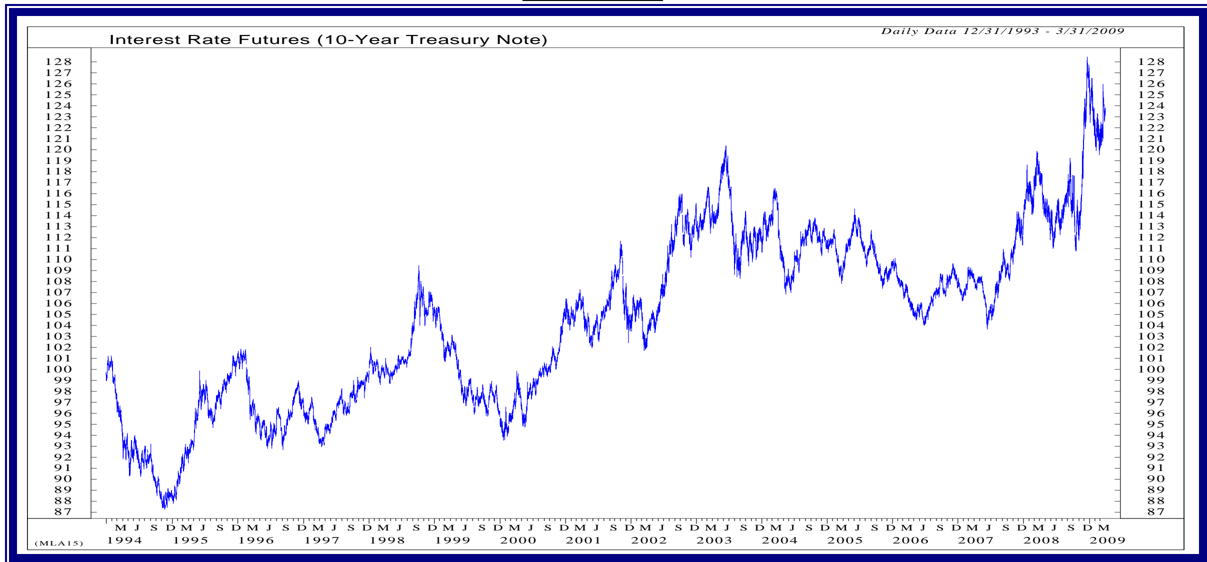
Source: Ned Davis Research

❖ **While in a distinct minority, we believe given the quick action of the new administration and the Federal Reserve that an economic turnaround is still possible by the end of 2009.** As a result we are still forecasting 1% real GDP growth in 2009 with corporate profits gaining 5.0% (as measured in the national income accounts) and CPI inflation of 2.0%.

An Update on the U.S. Fixed Income Markets

➢ **Although the economy remains stalled in negative growth, the clouds of uncertainty hanging over the capital markets are beginning to part.** The unprecedented amount of monetary and fiscal stimulus coupled with recent government interventions has gained traction. A number of indicators suggest that the pace of deterioration has finally begun to slow. For instance new orders for manufactured goods have popped off recent lows. The better tone promotes a healthier foundation for volatility to decrease to a more normalized level.

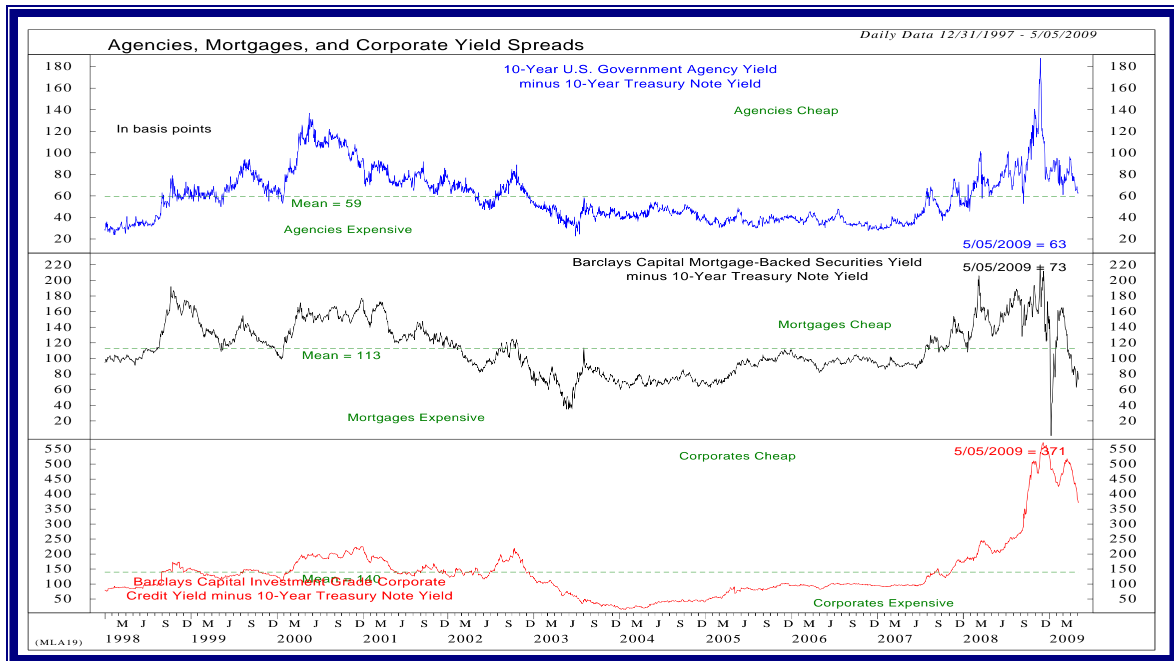
EXHIBIT III



Source: Ned Davis Research

- **A review of the credit performance for the first quarter shows an out performance versus stocks, with the intermediate bond market returning about 1.00%.** The best returns came from mortgages and corporates, reflecting a narrowing of spreads against U.S. Treasury. The case for lower yields over the next three months remains intact due to the quantitative easing by the Federal Reserve. The risk to this forecast stems from indicators showing surprise improvements in the economy. Mortgage refinancing will continue at a strong pace as the probability of lower rates exists in the future.

EXHIBIT IV



Source: Ned Davis Research

HIGH GRADE CORPORATES

- The new issue market keeps running full steam ahead as March was the busiest month so far this year with over $62 billion in non-financial and $82 billion in financial issuance on the month. New issues have generally performed well in the secondary market as issuers have been providing attractive terms to get the deal sold. A healthy new issue market provides the investor with reliable price discovery which is a key to demand in the secondary market. We are focusing on non-financial corporate issues with credit quality at 'A' rated or better and final maturities of 2-5 years.

PREFERRED SECURITIES

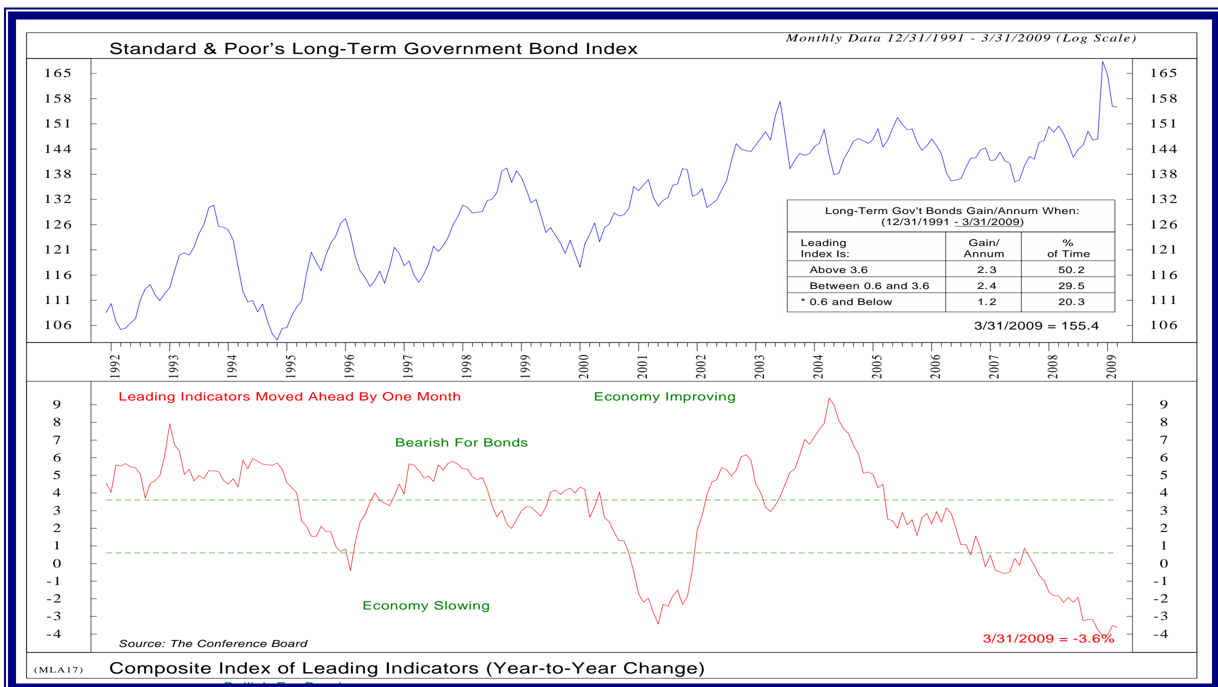
- The preferred market staged a rally in March despite some negative rating actions by S&P and Moody's in the financial sector. Some of the more credit worthy bank preferreds have also improved despite the up coming results of the so-called stress tests being run by bank examiners. For investors it is recommended that they remain in cumulative or enhanced Trust preferreds which are higher in the capital structure than non-cumulative preferreds.

- U.S. Credit Index nearly pushed itself back into positive territory in the last three weeks of December, with its best monthly total return of the year at 6.52%. It wasn't quite enough to offset the dismal performance in September and October, but it did help the index finish the year with a total return of -2.9%, not too awful considering all the turmoil we experienced last year. The option adjusted spread (OAS) on the index started December 2008 at 626bp giving the index a yield-to-worst of 8.22%.Currently the index has an OAS of 482bps with a yield-to-worst of 6.69%.

- We expect heightened volatility through the fourth quarter earnings period and potentially a short-term setback based on further hedge fund liquidations and profit taking from the rally. However, we maintain our positive stance on high grade credit for long-term buyers. We see the market gaining some traction as the year progresses, perhaps helped by further Federal actions, an improving new issue market that could provide some pricing clarity and the potential for increasing investor risk tolerance.

- We recommend keeping duration short for the time being, with maturities ranging from one to ten years. Financials still trade cheap to industrials and utilities, but we like companies that have a combination of the following characteristics: strong free cash flow, large cash balances or access to credit facilities, and are market leaders for essential service industries.

EXHIBIT V



Source: Ned Davis Research

MUNICIPALS

- Municipal bonds present compelling values for after-tax U.S. accounts, but uncertainties surrounding the impact of budgetary pressures are likely to generate above-average volatility in the near term. The combination of a steep municipal curve and dislocations among longer maturities, partly due to the exodus of leveraged players, provides particular value in the 10-year to 25-year maturity range.

- In our view, investors should continue to lengthen maturity and put cash to work. The likelihood of a full-blown default crisis in the muni sector, as many investors fear, remains exceedingly low, as we see it. On the other hand, there will be downgrades, particularly in local areas with severe housing or unemployment related pressures. In addition there are likely to be periods of market volatility as new issue supply "bunches up" in specific time frames, states, sectors or maturities. But we suggest viewing these as buying opportunities.

Our Positive Viewpoint on the Financial Markets

- **The equity markets got off to a rough start in the first quarter of 2009, contracting on fears over the severity of the global recession with many investment pundits drawing comparisons to The Great Depression.** The new administration has had a shaky start with regard to the Financial Stability Plan and the Public-Private Investment Fund which will buy the troubled assets of the banks. There have also been rumors abound concerning bank nationalization, which could potentially wipe out the equity of bank investors. As a result, combined with Eastern European banks, there has been a general loss of confidence. The revelation of a number of financial scams against a backdrop of the alleged Madoff Ponzi fraud has certainly not added to confidence either. At present, the Standard and Poor's 500 Index at 872.8 has staged a near term rally of 28.10% after a selling climax in early March when the Averages posted a decline of -23.9% year to date. The Morgan Stanley EAFE Index posted a -24.9% decline thru early March and has also recovered 29.3% of the loss in the recent rally. Foreign stocks have fared far worse over the past 14 months because of the strong dollar against the background of recession fears with attendant banking and insurance malaise.

- **Treasury securities had been the investment of choice as investors rushed to safety.** At present, this flight to safety had resulted in the 3 month Treasury bill yielding .20% in the end of March versus 0.3% a month earlier and 2.4% a year ago. 10 year Treasury bonds yielded 2.5% in the end of March versus 2.32% the month earlier and 3.9% a year ago. High quality long term corporate bonds yielded 6.48% at the end of the quarter compared to 6.36% a month ago and 6.32% a year ago. 30 year mortgage bonds yielded 4.6% versus 4.36% a month ago and 6.0% a year ago. Actions by the government have started to positively impact yields on mortgages. Investors in municipals bonds have been worried about possible defaults. Recently this fear has been elevated by California's recently settlement on its $42 billion dollar deficit and the federal stimulus plan focuses a good deal of money to many states and municipalities.

  It remains our belief that high quality long term corporate bonds and many municipal bonds at March end interest rate levels offer good value; we would be somewhat skeptical of the value inherent in government bonds at current prices.

- **Commodities at the end of March appear to have bottomed.** With the CRB Index at 215 down 33.74% from year-ago levels, oil ($49 per barrel) has rebounded down now -22% and copper -25% after dropping as low as -61% year over year only a couple of weeks ago. The Baltic Dry Index (1861) as a measure of shipping rates for raw materials has risen 104% over the past month as China has been purchasing raw materials for its economic stimulus plan. We also believe that equities have begun the long process of forming a longer term support level at current prices. The S&P 500 Index at 872.8 sells at 13.85 times the current estimate of $63 per share, according to Thomson First Call analysts, with a current yield of 3.3%. This profit estimate is down 9% for 2009 after an estimate of 20% in 2008.

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