FIXED INCOME STRATEGY HIGHLIGHTS

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THE U. S. FIXED INCOME MARKETS

Renewed concerns over Europe, mixed economic reports, and a correction in equities have helped support bond prices. Although we concluded last quarter that 10-year Treasuries were fairly valued at around 2.54%, we have determined that yields could fall further in the short term until we see more signs of capitulation from either bonds or equities. On the 10-year intermediate-term index, resistance appears to come in at around 1.70% and short term support can be found from 2.05% to 2.10%, with better support from 2.40% to 2.50%. So much for technical indicators, it would appear that Treasury yields continue to be poised to decline further in the near term, in sympathy with European developments.

It's no surprise that 10-year yields have stayed sensitive to the weakness in European Zone spreads. Despite already-low yield levels, 10-year yields declined by 35% of the widening in European Union spreads this week (an average of the 5-year Credit Default Swap spreads of Spain, France and Italy), close to the longer-term volatility of 37%. Although this persistent sensitivity is noteworthy, we believe there may some offset by the moderate risk of an eventual reversal towards higher yields in reaction to the potential dovish policy action by the European Central Bank (ECB). It does not appear that the odds of ECB support is very clear at this time. Maintaining only long positions in Treasuries are not among the better ways to express a risk-off view. Underweighting risky assets such as the S&P 500 or credit spreads offer a combination of better entry levels and better empirical convexity characteristics. Thus, faced with a bimodal outlook for rates, and given the relative unattractiveness of Treasury long positions even in a risk-off environment, we stay neutral on duration.

EXHIBIT I
10-Year Generic Treasury Yield

Source: Altman Investment Management Research and Bloomberg

Our longer term view of interest rates, barring a sharp economic contraction and/or deflation, is that a significant drop in interest rates from current levels is unlikely. To the contrary, some interest rate observers have suggested that the recovering economy and easy monetary policy could be setting the stage for a reversal of the thirty-year downtrend in interest rates that peaked in September 1981, with the 10-year hitting close to 16%. Our view has been that rates will move higher in time, but not to a significant degree over the near term.

Chairman Bernanke recently released the FOMC statement followed by updated economic projections. It was somewhat upbeat noting expectations of a gradual pickup in economic growth, some signs of improvement in the housing market and a lift in inflation. However, he also indicated at his press conference that if conditions deteriorate, the Fed stands ready to act. This was enough to offset the earlier hawkish tone. Overall the market reaction was muted, in sharp contrast to the response after the March FOMC statement.

We are cognizant that the U.S. economy still remains fragile. High structural employment, burdensome personal debt levels, challenged state and local budgets and a housing sector that remains depressed all cloud the outlook. Looming tax increases and budgets cuts next year, if Washington fails to take action, add further to the uncertainty. Additional stress stems from the European debt situation that appears to again be toxic, with slowing Chinese growth that may impact U.S. imports. Bernanke has indicated that monetary accommodation is likely to be required into 2014 to keep the economy from backsliding. Core inflation levels remain subdued due in part to the lack of wage pressure, but the Fed is keeping a watchful eye on Consumer Price Index as gas prices move higher.

Operation Twist, which began in November of last year, is scheduled to end this quarter, after $400 billion Treasury securities with maturities of three years and under are sold and the proceeds reinvested in longer government obligations. The Fed has reiterated the program's finale by stating that ending Twist is not considered a tightening policy. The looming question investors are pondering is - who absorbs the government's long bond issuance after the Fed exits? Additional support by the Fed may be required later to keep the bond market on even keel. Whether bold steps are needed (e.g. QE3) remains to be seen. However, we feel that the Fed will do whatever is necessary to keep the markets settled for the foreseeable future. Bottom line, don't fight the Fed.

At some point the Fed will have to reduce their market presence. While not likely at any time soon, their exit could precipitate market disruption that could lead to higher rates, especially if the federal budget remains significantly out of balance. That threat coupled with low prevailing interest rates that are, in most cases, providing negative real returns prompts us to maintain moderately defensive client account constructions. Portfolio durations remain targeted at 3.60 years, about 15% below neutral. Signs of stronger than expected activity and/or higher inflation rates would prompt us to further reduce durations.

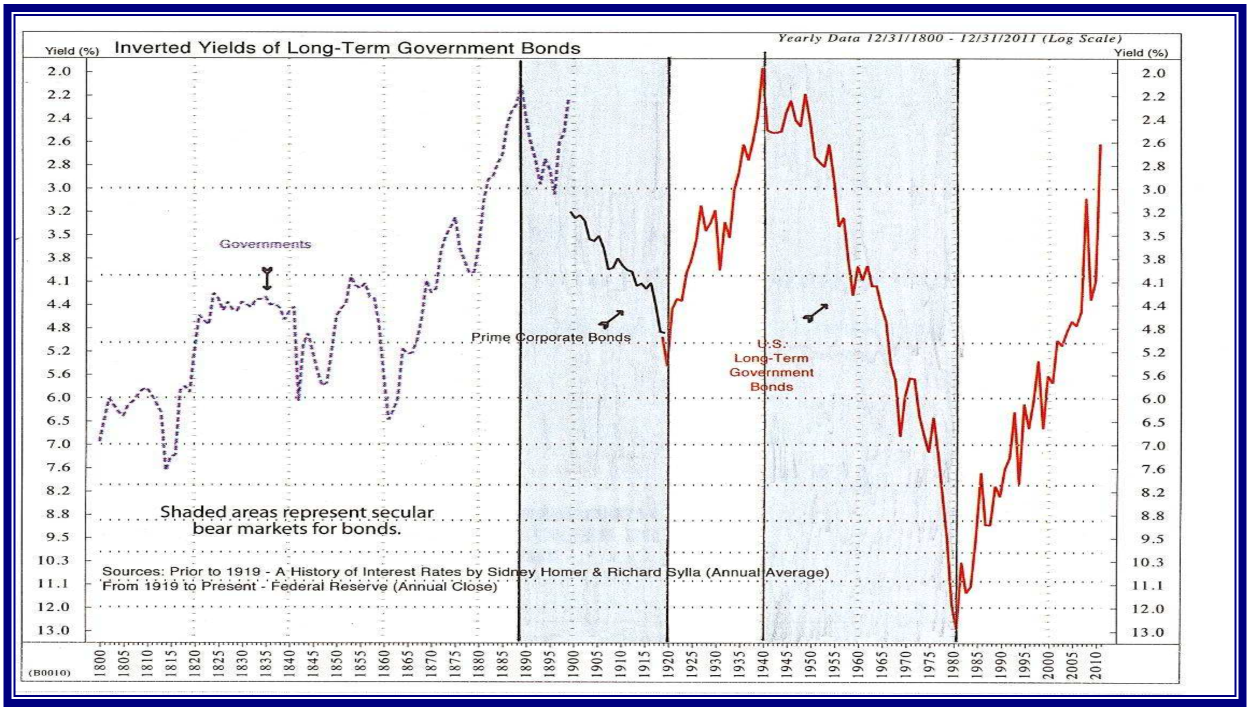
Historical Perspective

- ***Has the secular Bull Market ended for Bonds?***

There have been five secular moves in bonds since 1800 - three bulls and two bears. The latest bull has been the strongest, but not the longest (see Exhibit II). We have identified five characteristics that help us determine whether we are still in a secular bull market or have entered a new secular bear market: inflation trends, monetary policy, supply of credit, sovereign debt quality, and investor psychology.

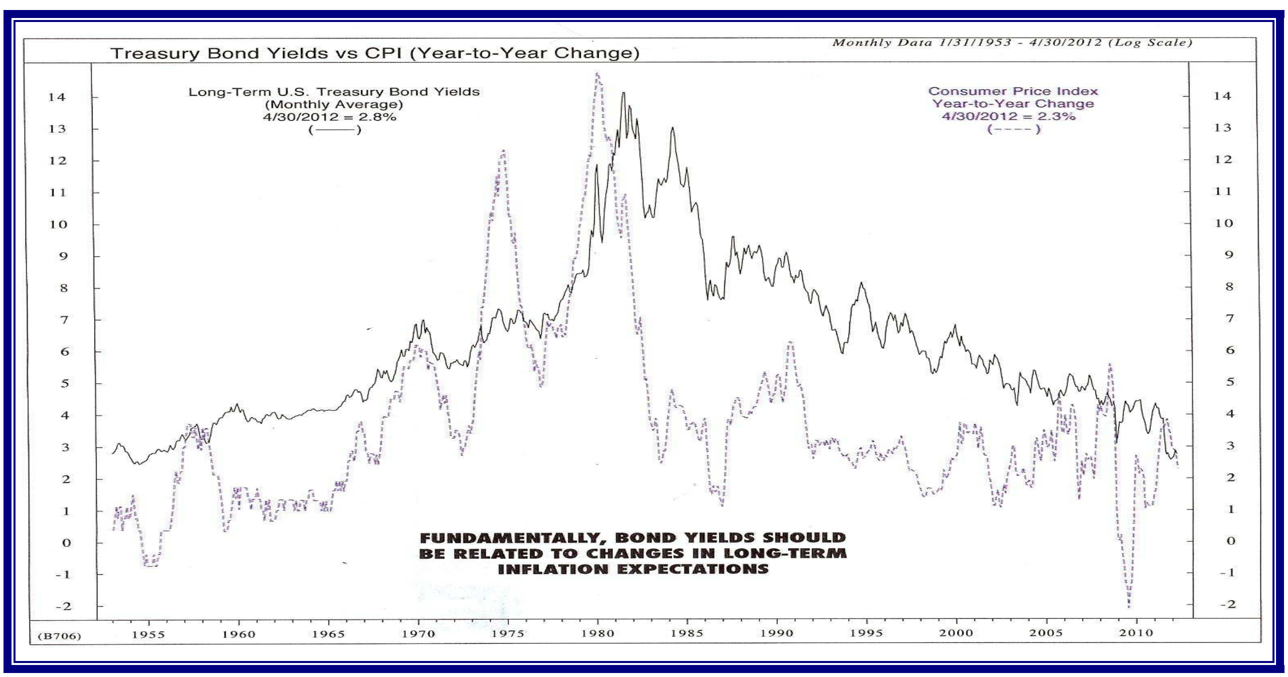
The secular bull market began in September 1981, with the long-term yields over 14% and inflation running at 11% year-over-year. Today, both are roughly 1.8%, as shown in Exhibit III. It took a long time, but inflation expectations have finally caught up to reality. With disinflation driving yields lower, bolstered by the Fed adding $2.1 trillion worth of Treasury agencies and agency Mortgage Backed securities (MBS) since 2009.

EXHIBIT II



Source: Ned Davis Research

EXHIBIT III



Source: Ned Davis Research

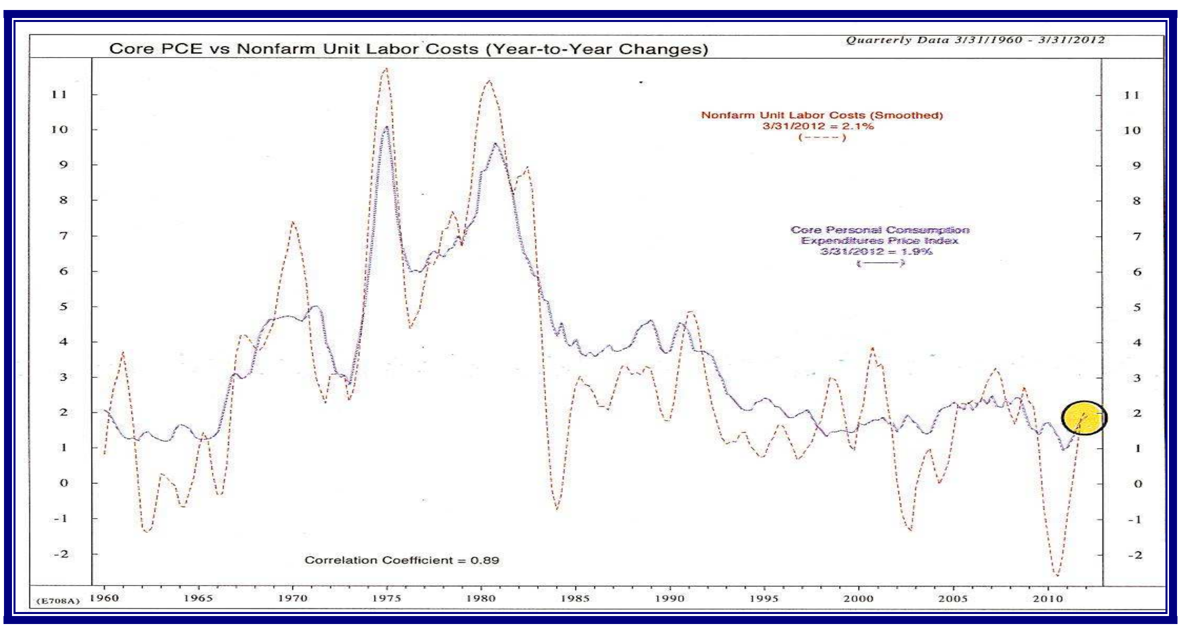
The deleveraging in the private sector has reduced the growth in oversupply. Last year for instance the bond market debt outstanding increased 1.4%, the smallest rise since the data began 30 years ago. Mortgage-back securities, which had been growing at a 15% per annum rate through 2007, have essentially shown no growth since that time. Agencies continue to disappear, along with asset-backed securities and commercial paper. Even municipals showed a decline in outstandings in 2011. Corporations which were net issuers of debt last year grew at less than half their normal pace. Investors who want to stay in fixed income instruments had no place to go other than Treasuries, which continue to grow at a robust rate, albeit slower pace. Investors who need or require the safety of government guaranteed debt (such as banks) have few alternatives. The share of government debt in the U.S. fell to a record low of 74% in March. That's down more than ten points since the mid-1990s. It's even worse in Europe, where less than half of the debt is government debt, down nine points pre-crises. With the German budget deficit shrinking, the lack of future supply could continue to drive bund yields lower.

With stocks yielding more than most Treasuries, investors remain cautious. The trend toward risk aversion for nearly five years has also supported bond prices and pushed yields lower. Fundamentally, the secular bull market may have largely run its course. Unless the Fed implements another round of QE, the small levers, not the big levers, are working to grind yields lower.

- ***Has the Secular Bear Market Begun for Bonds?***

With only the small levers currently working on the bullish side, it might be easier to examine the opposite question by examining the 5 characteristics mentioned earlier. First inflation pressures remain low for now. With the output gap large, inflation pressures are likely to remain contained over the intermediate term. Nevertheless there are some incipient signs of inflation. For example unit labor costs have rebounded in many industries, which tends to put upward pressure on core inflation

EXHIBIT IV



Source: Ned Davis Research

Rents are also moving higher with apartment property prices rising at double digit rates. These prices tend to lead shelter costs. Credit growth appears to have bottomed and is likely to be turning up, and commodity prices remain in a long-term up trend. This non-transitory rise in food and energy prices has caused headline inflation to consistently outpace core inflation over the past 10 years. Both commodity indices have appeared to have rolled over.

Although the FOMC will likely remain on hold until 2014, it won't remain on hold forever. Once the market expects the Fed to imminently tighten policy, yield will rise. As credit expands, bonds supply will increase. And it will follow that additional downgrades should theoretically result in higher yields and greater risk premiums, although that outcome is less clear for the U.S. at this time, considering the current environment and other alternatives. The end result will cause an increased appetite for risk, causing asset reallocation from fixed income to equities, pushing yields higher. In summary, although the secular bull appears to be ending, it is not clear that a secular bear in bonds has begun. With most Treasury yields at all-time lows, an argument can be made that the secular bull market is intact. In recent days the long bond has confirmed deflationary fears, and is currently yielding 10 less than its December 2008 low of 2.67%. It would appear that the bond market rally in recent days has begun what we see as a capitulation phase and could be a key turning point. We conclude that this historic low yield will turn out to be the top of the secular bull market in bonds.

First Quarter Overview

The wide range of performance between different sectors of the global bond market, by maturity and level of credit risk, reminds us that the bond market defies easy generalization. Not all bonds are created equal. During the quarter, there was a sharp price-driven appreciation in 'riskier' assets, such as corporate, high yield and emerging market bonds, while long-term Treasury bonds fell as yields rose. Overall, we expect we'll see similar performance by sectors through much of the rest of 2012, with yields rising modestly for Treasuries on improved economic data, with periods of volatility and re-trenching if we see weaker data or concerns about global growth.

The Barclays U.S. Aggregate Bond Index turned in a meager performance over the first quarter, delivering 0.3% in total return on the combination of coupons, and a modest drop in the price of the index as yields for government bonds rose sharply in March. For those focused on income, the index is now yielding north of 2.2% with an average duration of just under five years (i.e. the weighted average timing of interest and principal payments, and a measure of interest rate risk). We expect that income will drive returns for much of the rest of this year, with a range on interest rate risk most likely through year-end.

High-grade corporate bonds were the primary beneficiary of increased risk-appetites and yield-chasing, a theme that's continued from late 2011 into 2012. But performance was not spread out evenly across asset classes. The financial and banking sectors, laggards as recently as Q3'11, beat utilities and industrials over the last 3 months. This is thanks in part to improving market conditions and no real negative surprises in the Fed's recent bank stress tests. Few investment-grade sectors look cheap now, a concern for investors who have been looking for yield and pouring money into corporate bonds. We're more cautious at the moment, given the strong recent run. It may make sense to look for opportunities when they present themselves at more attractive levels. The cycle, to us, still favors credit.

Government-Related Debt/MBS

- **Treasuries are likely to be range bound in Q2'12**, which is why we don't currently like the sector because of the abnormally low yields. The impact on U.S. rates in the event of a hard landing in China while not insignificant, and the sensitivity of Treasury yields to European weakness, is small in comparison to the other key drivers of 10-year yields; we estimate that Treasury yields are likely to fall another 15bp if growth in China were to moderate by an additional 3%. We stay bullish on some inflation protected securities. In recent months, two-year Agencies have traded in a tight range, near the richer end of our valuations, which is why we like longer durations versus Treasury.

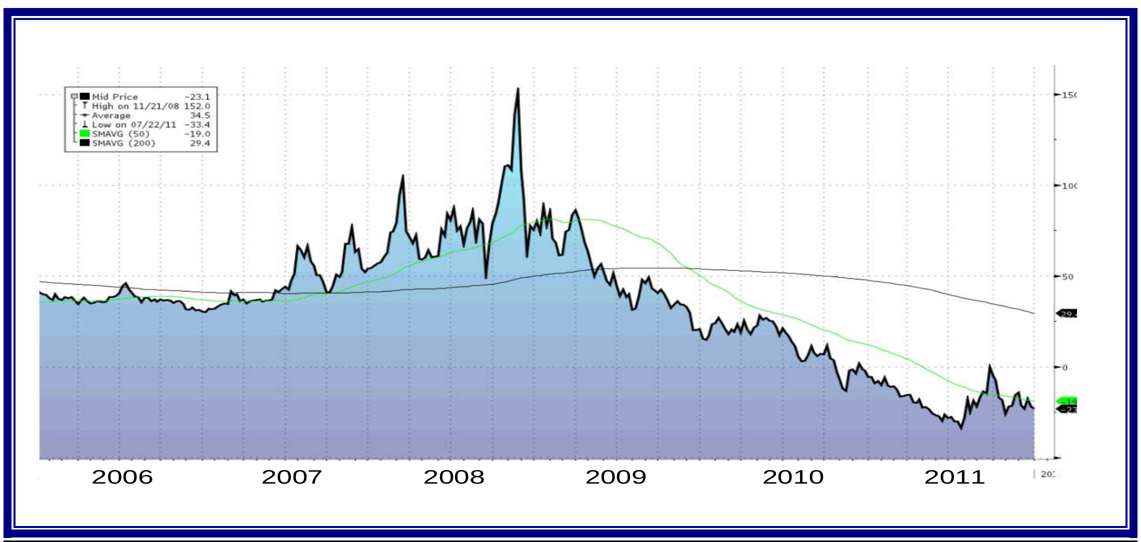
EXHIBIT V

7-10 Year U.S. Treasury/Agency Yield

Source: Altman Investment Management Research and Bloomberg

EXHIBIT VI

10-year U.S. Agency (Fannie Mae) Yield minus 10-year Treasury Yield



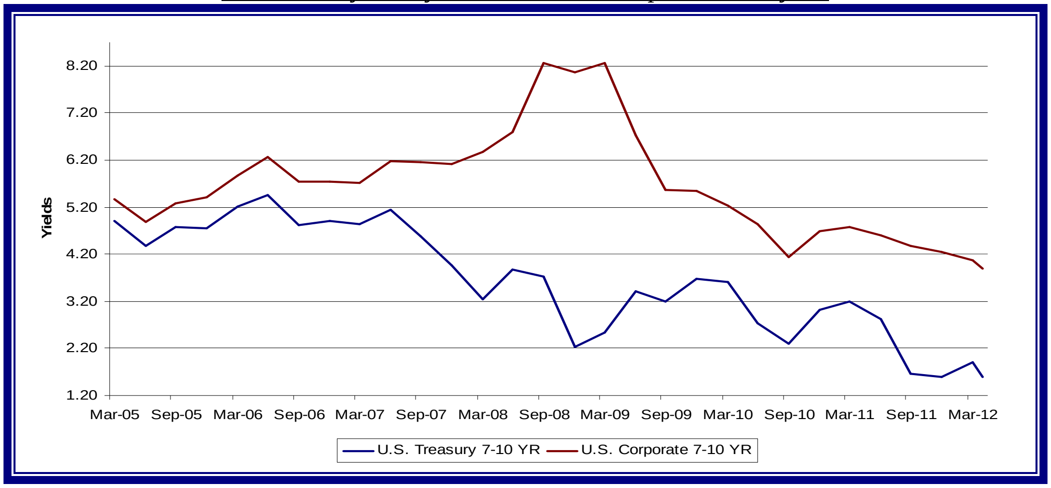
Source: Altman Investment Management Research and Bloomberg

High-Grade Corporates and Preferreds

- **We remain overweight on Investment Grade (IG) credits, while maintaining our view that year-end spreads should tighten an additional 25 basis points versus today's levels.** In the near term, we believe renewed uncertainty in peripheral Europe will limit the ability of spreads to tighten meaningfully over the next couple of months. This will counter more positive developments that we expect in Chinese growth and the longer term positive supply/demand dynamics in IG credit. We are not moving to an underweight view, because we expect intervention in Europe if/when conditions deteriorate, and we believe supply/demand are fundamental drivers of high grade credit - and we remain supportive of lower spreads over time.

EXHIBIT VII

U.S Treasury 7-10 year versus U.S. Corporate 7-10 year



Source: Altman Investment Management Research and Bloomberg

Municipal Bonds

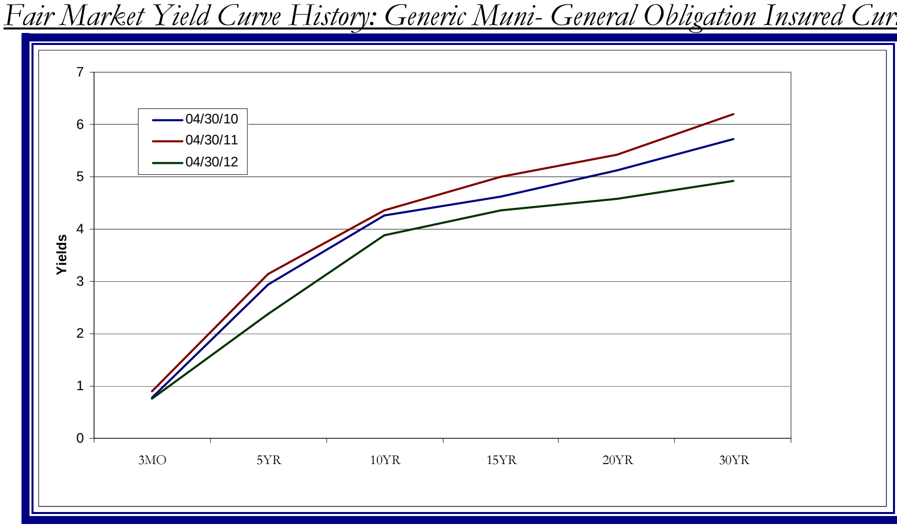
- **Municipal bond funds have experienced 19 consecutive weeks of inflows**, with YTD inflows totaling $17.5bn. Tax-exempt rates fell following the rally in Treasuries; significant high-grade supply in the future may lead rates somewhat higher.

- **Intermediate funds have received $4.8bn and high-yield funds have had $2.9bn inflows.** Inflows have been supported by strong year-to-date market performance, with 2.38% total return as measured by S&P Municipal Bond IG Index. We expect performance to be at least steady heading into Q2, with the risks being a large sell-off in the Treasury market resulting in a sharp hike in yields or a serious credit event, neither of which appears to be on the horizon.

- **Municipal rates fell significantly in the last three quarters of 2011 which produced capital gains and strong total returns.** We expect the upcoming new issuance will be heavier than last year's schedule and will continue to be structured with lower coupons and static average maturities.

EXHIBIT VIII

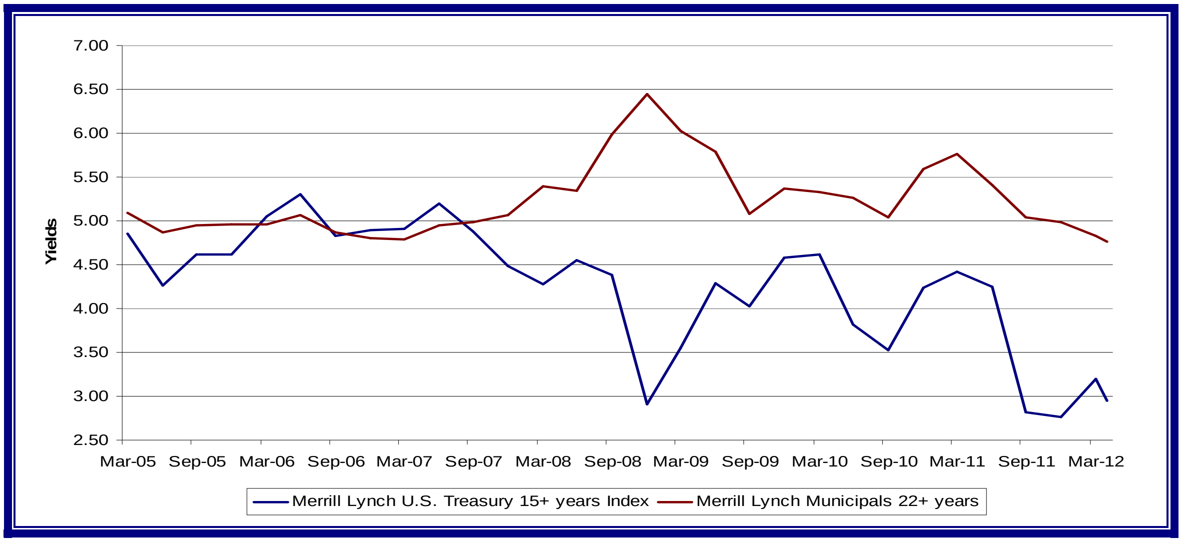
Fair Market Yield Curve History: Generic Muni- General Obligation Insured Curves



Source: Altman Investment Management Research and Bloomberg

EXHIBIT IX

Long Term Municipal to Treasury Spreads

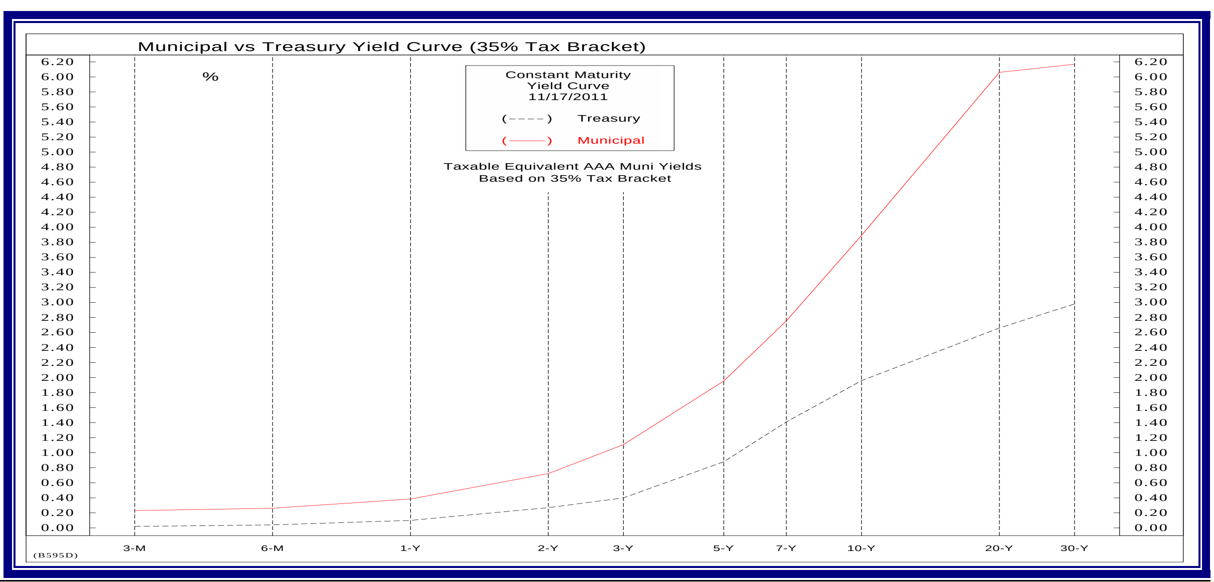


Source: Altman Investment Management Research and Bloomberg

For the benefit of our bond and balanced investors, our traditional accounts are measured against the Merrill Lynch 1-10 Year Domestic Master and have an average duration of 3.4 years and an average maturity of approximately 5 years. Both products have a conservative orientation that controls risk in the form of volatility. Our primary objective in managing these assets is not to incur total return losses in any year. Limiting portfolio durations provides us with the confidence that this objective will be met.

EXHIBIT X

Municipal to Treasury Yield Curve (35% tax bracket)



Source: Ned Davis Research

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