FIXED INCOME STRATEGY HIGHLIGHTS …. AUGUST, 2008

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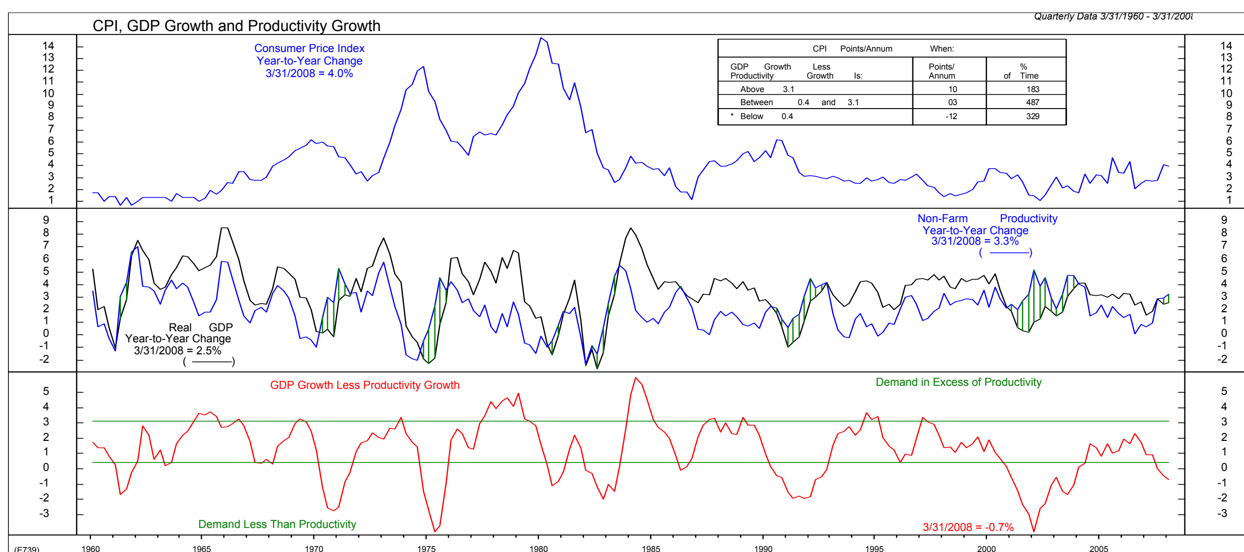
GENERAL MARKET OBSERVATIONS

Renewed credit concerns have reignited the flight to quality that had diminished since March. Government debt rallied, while spreads in the cash and credit default swap markets rose sharply. Futures markets pulled back from aggressive expectations for further Fed and ECB rate hikes this year. European Union policymakers lifted their target by 25bp but struck a more dovish tone, confirming that more near-term tightening moves were unlikely. The tug of war between deteriorating growth prospects and stubborn price pressures persists. While we believe slowing growth will ultimately overtake inflation concerns, we recommend that investors remain somewhat defensive.

As safe haven appetites have increased, willingness to retain credit risks in investment portfolios has waned. Investment-grade and high-yield corporate bond spreads relative to Treasuries have backed up to early-April levels; credit default swap spreads in both markets are near March highs. While mutual fund flows are lagging indicators, high-yield funds have been witnessing outflows after substantial inflows for nearly two months. It should come as no surprise that high-grade momentum is being led lower (that is, to wider spreads) by expectations for additional write-downs at financial institutions while auto manufacturers are leading the junk bond market, particularly relative to recent developments at General Motors. Other high-quality debt sectors have suffered, especially those related to housing. For example, triple -A agency debt spreads are trading about 2 1/2 times their long-term norms and high-quality mortgages are nearly three times historic averages. In aggregate (encompassing corporate bonds, conventional mortgage-backed securities, agencies and swaps), average normalized spreads are nearly 2 1/2 standard deviations above long-term norms.

Figure I



Source: Ned Davis Research

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THE U.S. ECONOMY

- **Consumer sentiment, released by the University of Michigan, inched up to 61.7 in August from 61.2 in July.** Despite the recent improvement from the low of 56.4 in June, sentiment is still below the trough of the last two recessions. The drop in energy prices is likely responsible for the increase in sentiment over the past two months. However, housing weakness, turbulent financial markets and rising unemployment has continued to dampen consumer moods. About 56% of respondents reported a worsening of their financial situations, above the 53% recorded in July. And only 21% of respondents expect any improvement in financial prospects over the next year.
- **Although energy prices have started to edge lower, they are still quite high, which has discouraged purchases of vehicles.** The index of buying conditions for vehicles has fallen to the lowest level in about 25 years (Figure 1). About a third of consumers complained about high gas prices and fuel inefficiency of the current models. In addition, many consumers cited uncertainty about future job and income prospects as a reason to postpone plans to purchase a vehicle.
- **The recent decline in energy prices has reduced inflation expectations.** Consumers expect inflation to average 4.8% over the next 12 months, down from 5.1% in July. Long-run inflation expectations held steady at an annual rate of 3.2%, down from 3.4% in June and May. The recent decline in long-run inflation expectations has likely provided a sense of relief to the Federal Reserve.

Figure II

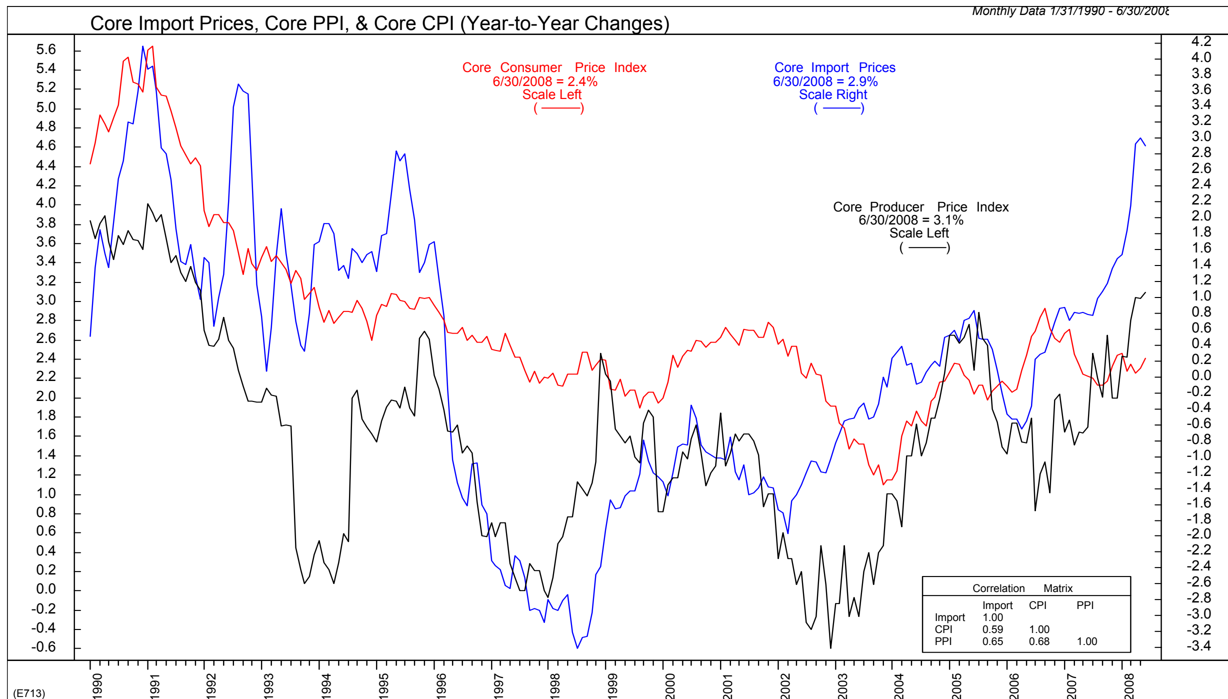

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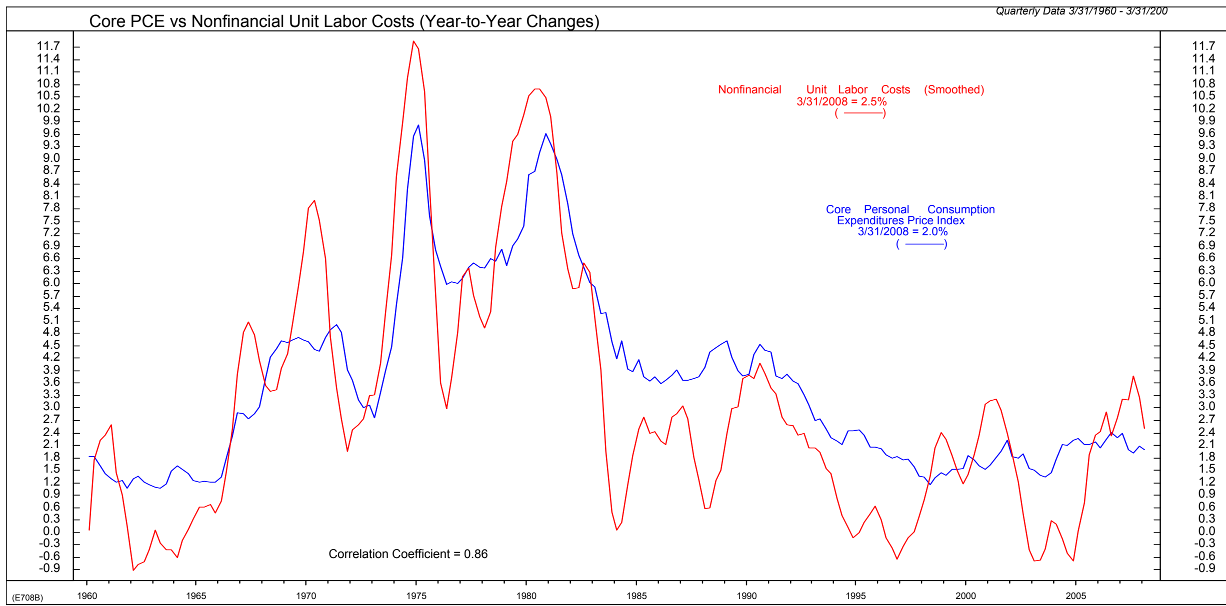
Figure III



Source: Ned Davis Research

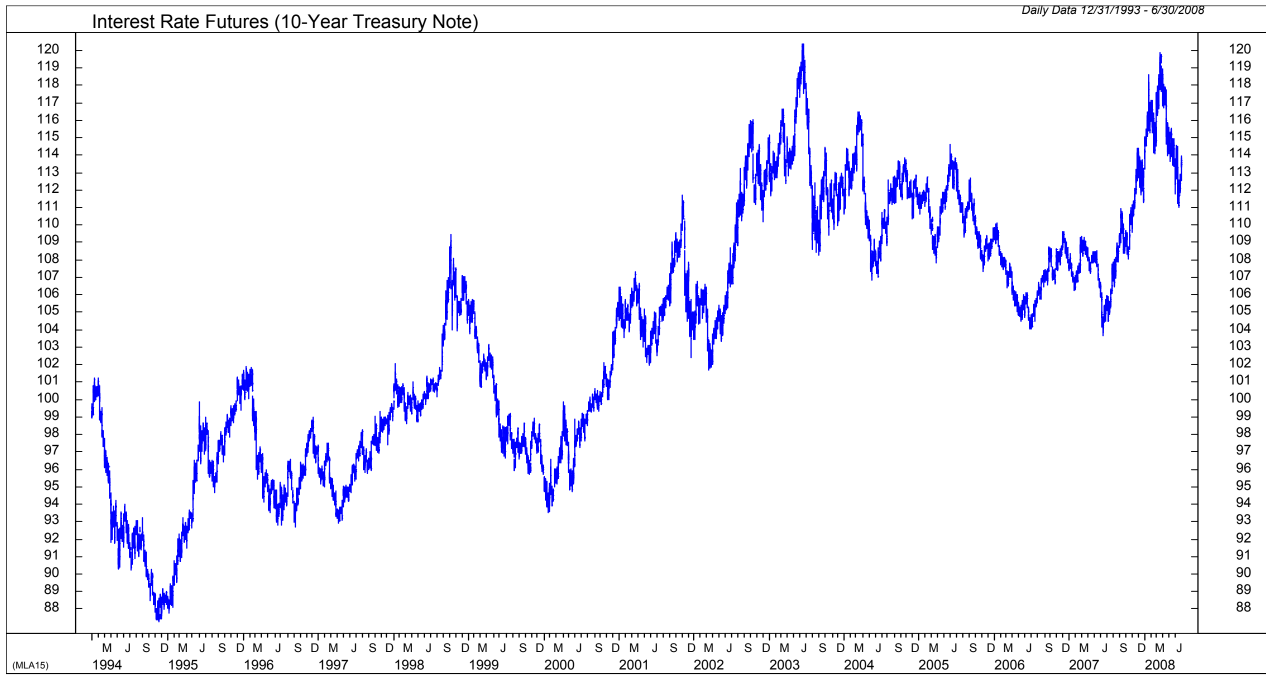
THE U.S. FIXED INCOME MARKET

- **Both domestic corporate bonds and U.S. agency mortgage pass-through securities easily out performed 1-10 year Treasuries during the 2nd quarter.** Longer term interest rates rose on worries of higher inflation and a weaker dollar. We maintain that prospects for much higher interest rates at this stage are too aggressive considering the drag from declining confidence, higher gasoline prices and a weak job market. Indeed, in the near term, we believe that rates are probably range bound, with prospects for U.S. short-term rates to move higher (and steepening the yield). While, the Federal Reserve and the ECB are unlikely to raise rates this year, that's largely contingent on ratcheting back price pressures. The Bank of England, meanwhile, faces greater challenges since inflation expectations have become unhinged, which may force a rate hike despite its current economic woes.

- **The trend toward higher global bond yields is probably still intact.** This should occur as market conditions normalize in the medium term, particularly in the United States, led by the front end of the curve. Moreover, unless the global economy falls entirely out of bed, benchmark yield curves, for instance, should reflect a receding flight to quality as the credit crisis ultimately concludes and investors have more appetite for risk.

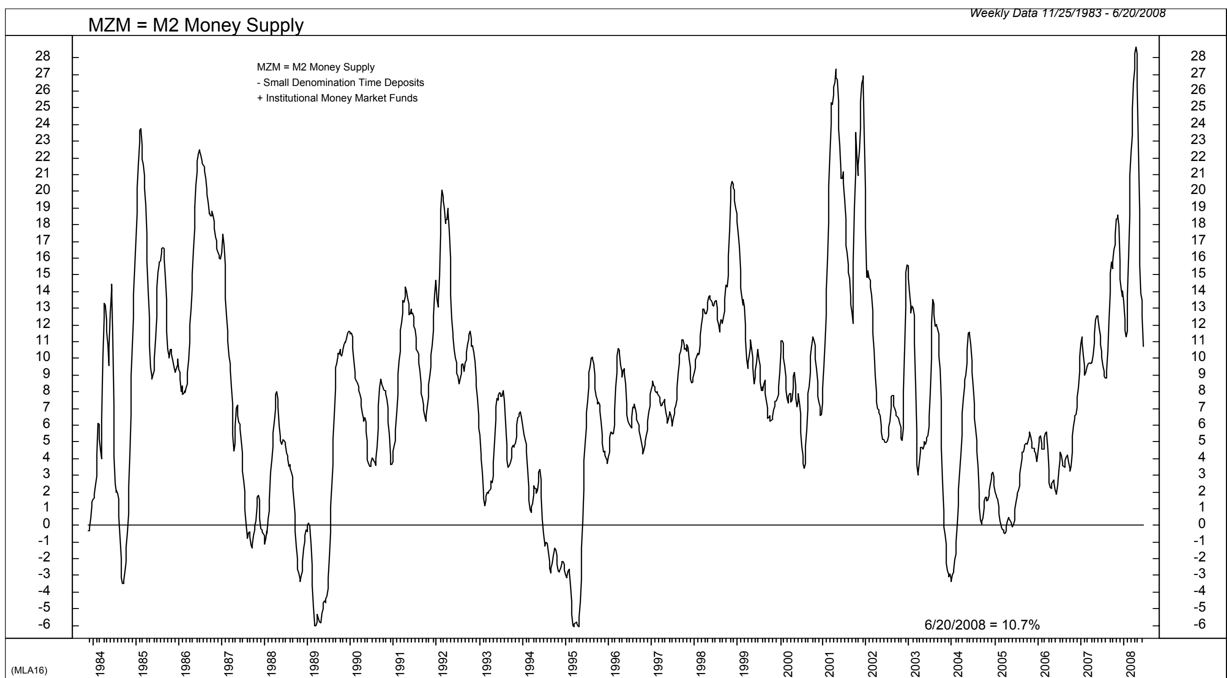
- **We continue to believe that possessing a good defense in the current climate makes good sense – stick to high-quality, plain-vanilla securities and select opportunities in the riskier market sectors.** We are cautious about taking low-quality bets (a rising high-yield default rate and further strains in the credit markets will provide more attractive entry curve) as the year progresses and for euro/UK rates to decline (causing their curves points later this year, in our view), adding duration or reaching for yield to achieve predetermined bogies. In addition, bond investors should garner sufficient liquidity premiums for even high-quality investments that might be subject to longer-than expected impaired market conditions (i.e., asset-backed and structured investments). We do not advocate that investors sell high-quality holdings into the unattractive valuations typical of these fragile markets, as long as those investments remain consistent with long-term investment objectives.

Figure IV



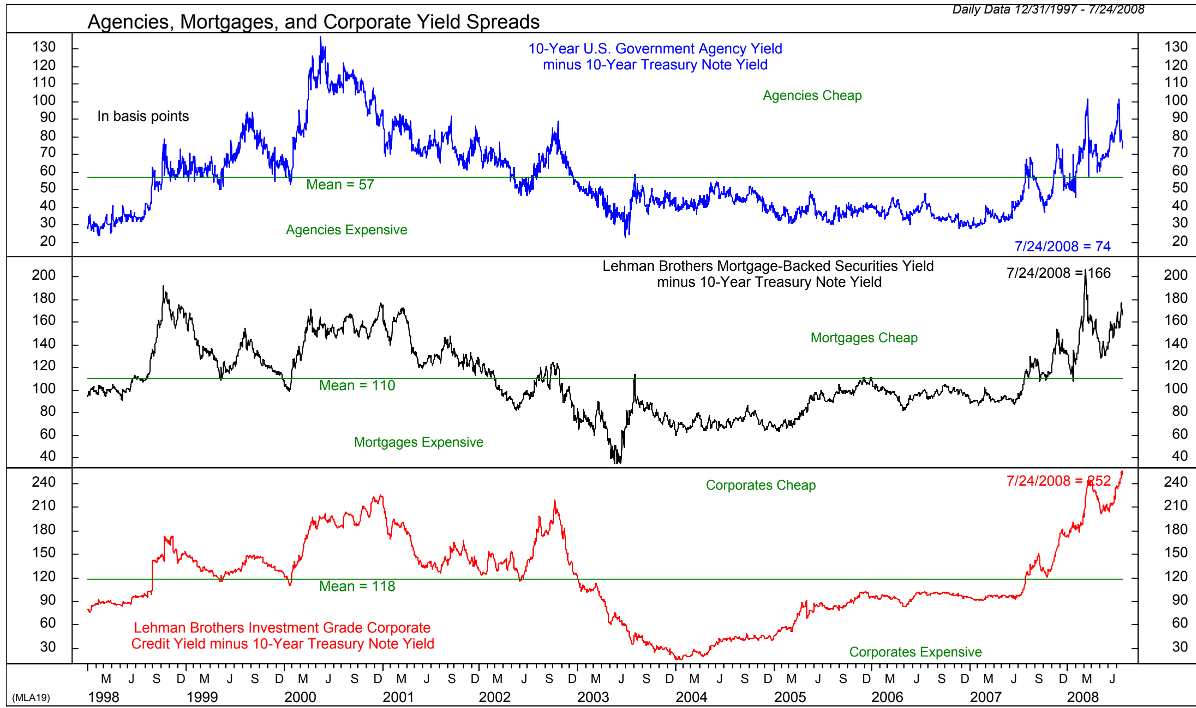
Source: Ned Davis Research

Figure V



Source: Ned Davis Research

Figure VI

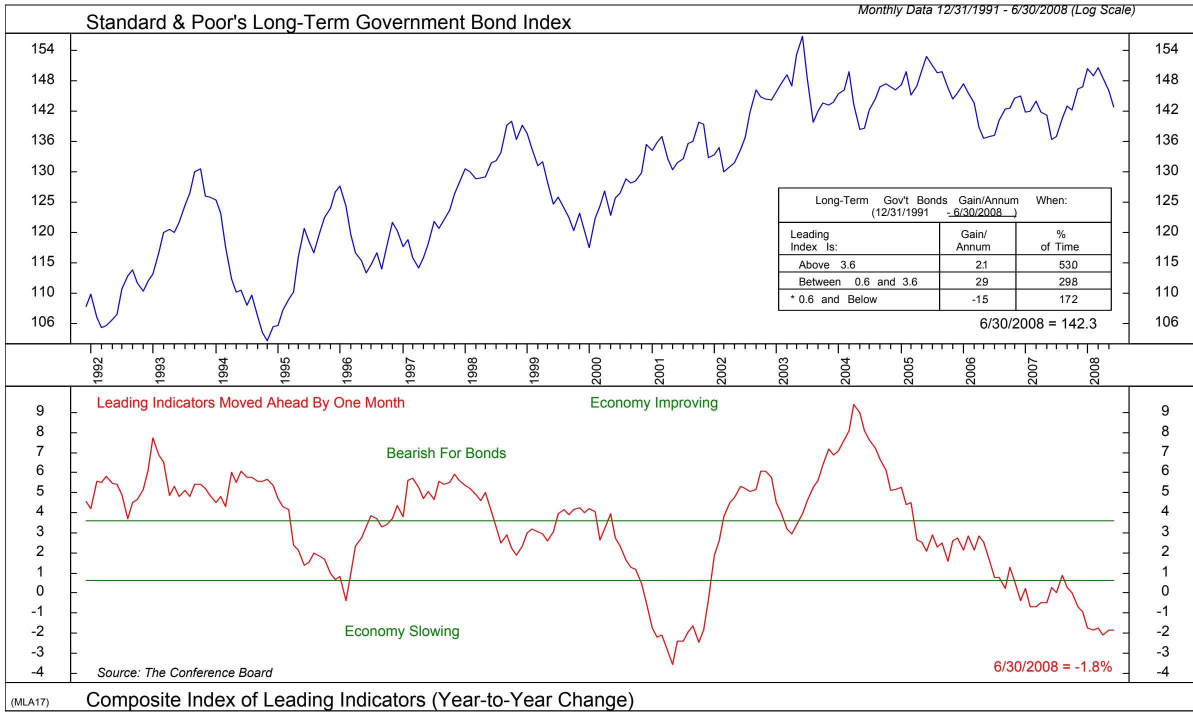


Source: Ned Davis Research

- **The pressure on munis comes from several sources including the continual stream of bond insurer downgrades.** While specific ratings vary greatly, the rating level means little for any of the insurers except the three that remain triple A: FSA, Assured Guaranty, and Berkshire Hathaway. For any other insurer, bonds are trading based almost exclusively on the underlying credit strength of the issuer, and in some cases, identical bonds trade to a lower yield without bond insurance than they do with it. While the increases in yield are fairly modest, they have come during a period when Treasury yields were actually declining. As a consequence muni yields as a percentage of Treasury yields have bounced back fairly sharply. Indeed, all along the yield curve muni yields as a percentage of Treasuries are almost at peak levels. On long maturities in particular, the extra yield is impressive, in our view. For 30-year maturities, the average yield as a percentage of Treasury yields for high-grade munis for the past 12 years is 90.5%. At the close of business on July 1, 2008, the ratio was just under 105%. In the five-year range, the average ratio is 77.8%, and the current level is right at 100%.

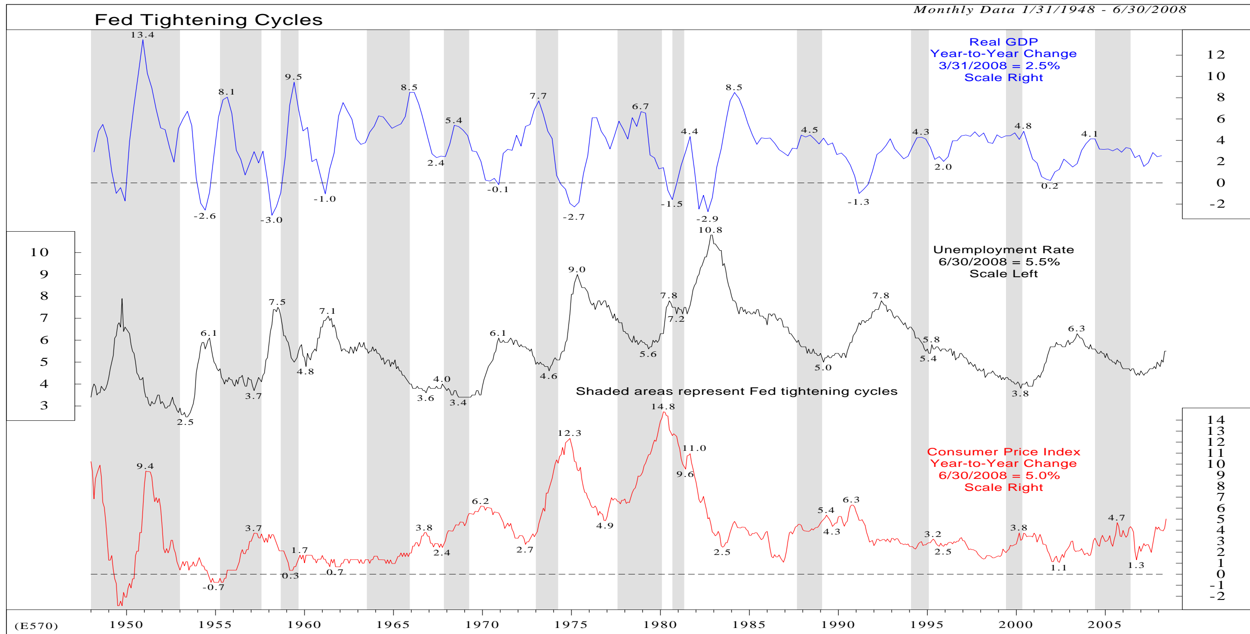
- **A number of factors contributed to the cheapening of munis in comparison with Treasuries:** (1) a renewed flight to quality as global and U.S. investors became more worried about the U.S. economic outlook; (2) downgrades of previously triple -A bond insurers and the resultant jettisoning by money market funds of variable -rate paper guaranteed by these insurers; (3) purchases of some of the high-yielding VRDNs by buyers who otherwise would have been focusing on the long-term market; and (4) a handful of liquidations of leveraged positions because their funding source was no longer money market fund eligible.

Figure VII



Source: Ned Davis Research

Figure VIII



Source: Ned Davis Research

FIRM UPDATE

Altman Investment Management is celebrating its seventh year managing investments for our valued clients, and still hold steadfast to our commitment to serve our clients and investment partners in good and more difficult times, by achieving both consistent and superior investment performance relative to our benchmarks across both equity and fixed income classes. Our singular focus on investment performance and exceptional client service, with seasoned investment professionals, continues to solidify our long-term partnerships. To further accommodate our growing client needs we continue to enhance our product suite and team of professionals dedicated to continuing our tradition of achieving the superior results that our clients should expect and deserve. We recognize that over the past few months it has not been particularly easy to stay the investment course, especially during volatile periods in the markets. During these times of uncertainty, we especially appreciate our clients, business partners and friends for their continued confidence in our process, expertise and long term vision.

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