FIXED INCOME STRATEGY HIGHLIGHTS

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THE U. S. FIXED INCOME MARKETS

Brief Overview

It is a wonderful thing how monetary policy has kept the market so buoyant. Over the past two months, global and domestic economic data have come in weaker than expected, excluding the U.S. July jobs report, and the European sovereign debt crisis has officially engulfed Spain. July experienced another decline in interest rates as the Federal Reserve talked in the August FOMC meeting of the possibility of further quantitative easing. This coupled with another speech by ECB President Mario Draghi has left the impression that monetary policymakers are willing to come to the rescue when required. This "put" from the central bank has fostered a very strong technical backdrop in the credit markets, and spreads continue to grind tighter despite stretched valuations and weak macro fundamentals. Since the end of June, Investment Grade spreads have tightened 38bp, and High Yield credit spreads have tightened 88bp. At a current level of 176bp, Investment Grade (BBB-AAA) spreads are very near the 12-month low of 163bp. In addition, the yield on the Barclays Capital U.S. Aggregate Investment Grade Index (average maturity over 8 yrs.) has dropped below 3% for three straight weeks near the 12-month low of 163bp. Current spreads on the Barclays Capital U.S. Aggregate High Yield Index is 570bp, only 11bp shy of the 12-month low of 559b.

Many investors have been concerned about a double dip recession similar to what is currently experienced in Europe. As a result, 10-year Treasury bonds currently yield an historically low interest rate of 1.38% versus 1.6% only a month ago. This environment has forced investors to reach for yield, combined with very strong technicals is the most obvious explanation for the resilience of the credit markets. Fund inflows and low net issuance, coupled with maturities and coupon income, have left many funds with excess cash to put to work. Add in the fact that many investment funds are accepting credit risk to achieve yield bogeys they cannot otherwise get in traditional safe-haven assets. Money supply as measured by M-2 is currently growing at an annual rate of 4.6% on a three month annual basis versus an elevated 6.6% growth over six months and even higher on an annual basis. While money is being printed at an elevated rate, the velocity has declined primarily as a result of slowing economic activity.

All of this has left bond investors with a market that looks unusually strong given the macro risks on the horizon. In effect, monetary policy is working as its forcing investors to take on more risk; it is essentially forcing a rally with reluctant investors.

U.S. Government Market

The U.S. Treasury market continues to be reacting to news events, and appears to be anticipating some central bank policy action sooner rather than later. As far as the Fed goes, in terms of economic impact, we have moved from the law of diminishing returns to one of negligible effect. Instead, potential Fed easing appears to be more of a way to counter or arrest negative market sentiment. With respect to potential ECB policy action, while a rate cut would be welcome, it would most likely not have the same impact on the markets as would a straight forward resumption of sovereign debt purchases. Overall, we feel even coordinated action would produce only near-term positive effects on the risk markets. Nevertheless, the UST 10-yr could continue to sell off in such an environment, but it would only take the yield to the back end of our 1.20% to 1.75%/2.00% range. Technical work suggests 1.67%/1.72% as a primary yield resistance (level of increased trading activity occurred previously). As we have noted for some time, volatility remains elevated. For some insights, the UST 10-yr yield posted a low of 1.39% as recently as July 24, and stood at 1.77% as of this writing.

Based on our expectation of moderating growth trends and the assumption that investors would eventually lose confidence in committing funds to investment portfolios that are providing negative real returns, we believed that interest rates would not move significantly lower and instead more likely move higher in the months ahead. That was not quite the way it happened in the second quarter. Several key factors - renewed Euro-zone pressures, coupled with additional signs of a sluggish U.S. growth as the first quarter GDP was revised downward, retail growth simmered and job gains dropped below expectations – have all encouraged investors to again favor the safety of the Treasury market.

The risk of significant tax increases and government spending cuts at year end, the so-called "fiscal cliff," continues to loom over the U.S. economic recovery. Although these threats are very real as 2013 unfolds, we expect Washington to dampen these potential drags. Comprehensive budget and tax reforms seem relatively unlikely in the face of an upcoming election. We would expect continuing resolutions that maintain the status quo until after the election of both the presidency and the Congress. While fiscal policy is somewhat uncertain, monetary policy remains accommodative. We believe that short rates will be maintained near zero for several quarters, while Operation Twist has been extended and Chairman Bernanke has indicated that the Fed will take further action if it is called for. Given the recent sluggish job growth, we would expect that the third round of quantitative easing (QE3) remains in the Fed's playbook.

EXHIBIT I

Ten Year Generic Treasury Yield

Source: Altman Investment Management Research and Bloomberg

On closer examination, the concern over a sluggish U.S. economy, a global flight to safety, and the purchase of longer dated securities by the Federal Reserve resulted in a decline in interest rates, particularly among longer maturities, during the second quarter of 2012. Yields on 7-year Treasury obligations declined from 1.6% to 1.1%, while the yield on 10-year Treasuries declined from 2.2% to 1.65%. Shorter term yields remained relatively unchanged, with 2-year Treasuries at 0.30% at the end of June versus 0.34% as of the end of March. It is still possible on a short term basis to see some further declines in longer term rates, given the likelihood that the Federal Reserve will undertake another round of quantitative easing in response to continued economic sluggishness. However, we continue to emphasize the longer term risk of a meaningful rise in interest rates, as fixed income markets remain vulnerable to evidence of accelerating economic growth. On this basis, our strategy is to maintain a shorter than average maturity in our fixed income portfolios.

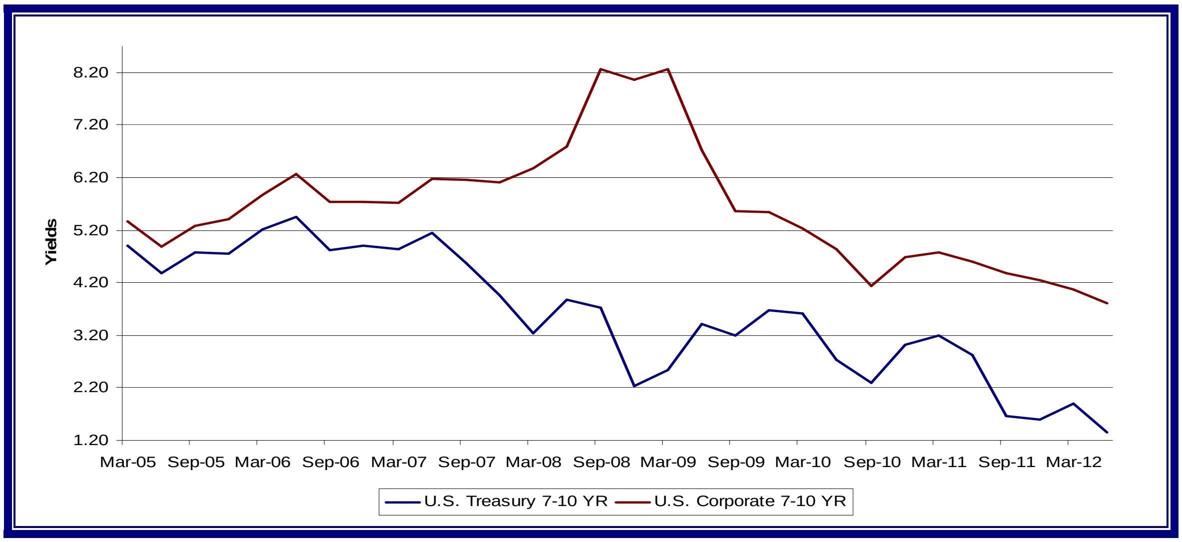
Corporate Market

Corporate bonds have done very well this year. Year-to-date spreads are tighter across the board and a drop in risk free rates has boosted total returns especially in longer duration credits. Yet, we are now faced with a conundrum, valuations are relatively rich based on several different metrics and, as we discussed above, the macro backdrop may have to worsen before the central banks are willing to act.

Valuations in Investment Grade credit have also reached relatively rich levels, especially on a national yield basis. Yet, the spread on the index at 176bp remains wide of the long-term average of 133bp, providing some cushion. Of the two asset classes, Investment Grade credit will remain much more stable than High Yield in a risk off environment, and we believe investors will continue to be attracted to the yield pick-up of Investment Grade corporates over risk free assets, in our view.

EXHIBIT II

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



Source: Altman Investment Management Research and Bloomberg

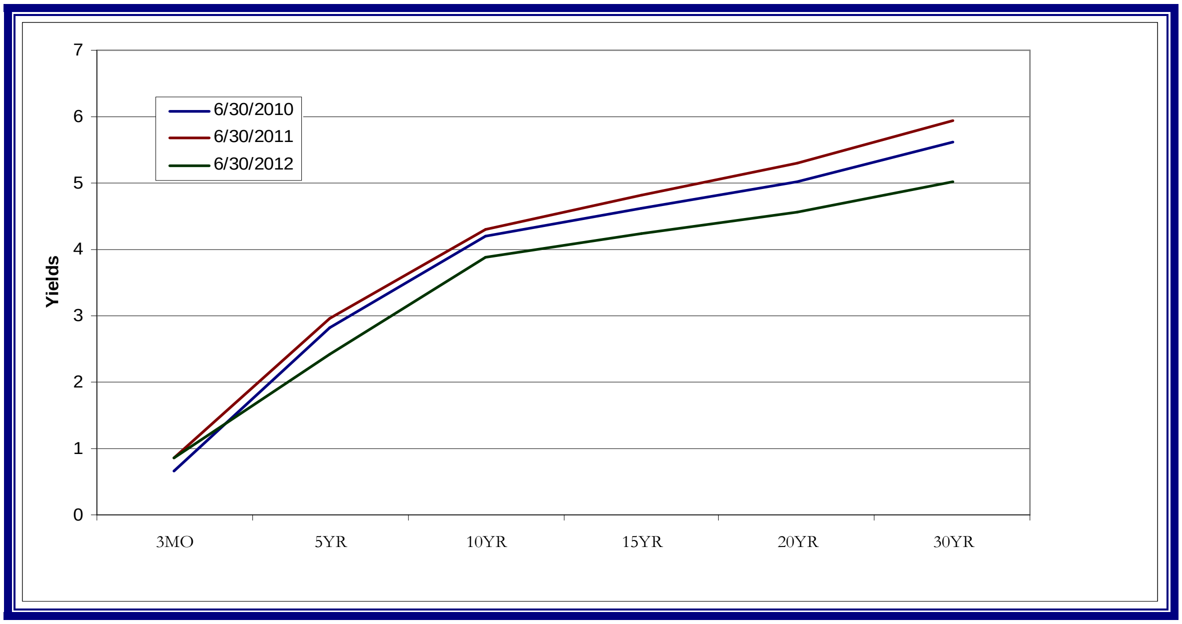
Barring any sharp sell-off in Treasury securities, munis are poised to continue to perform well in the near-term. We see supply as healthy but not disruptive to the market. At the same time, investors are flush with cash from heavy bond redemptions, helping create favorable supply/demand dynamics for the market. In our view, muni yields are cheap relative to yields on Treasury securities with comparable maturities. Also, the prospect for higher future federal tax rates is apt to boost the appeal of tax-exempt munis for certain investors.

Municipal Market

Since July 1, municipals have now outperformed Treasuries. To provide perspective, 10-yr state GO yields have fallen 15bp, as of this writing, as compared to the UST counterpart maturity where the yield has remained flat at about 1.65%. Obviously, there has been a great deal of volatility within the UST market in recent weeks, which actually masks this divergence. Indeed, as mentioned previously, the UST 10-yr yield actually got to as low as 1.39% in late July. If one were to look at the movements over this few weeks span, the 10-yr muni yield is up a rather modest 9bp while the UST 10-yr is up 25bp. The forces, which we just highlighted for the municipal underperformance, were basically reversed this time around — in particular, the supply/demand dynamic. Nevertheless, relative value still exists in the municipal space as the 10-yr AAA state GO ratio to the comparable Treasury still stands at just under 110%.

EXHIBIT III

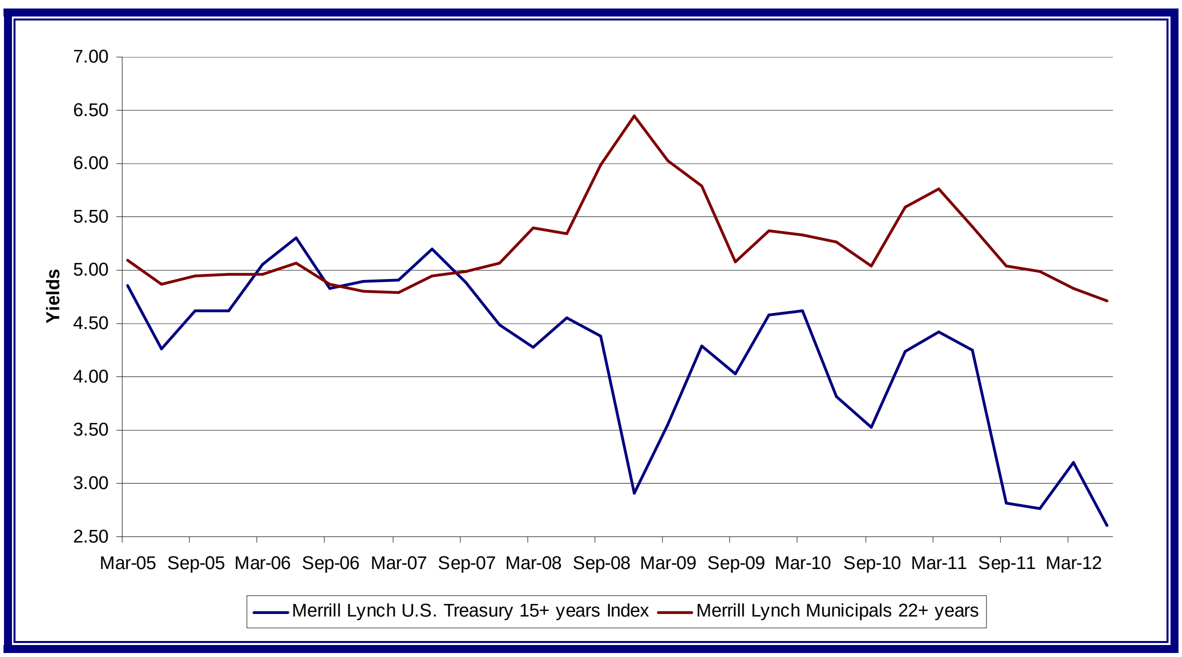
Fair Market Yield Curve History: Generic Muni- General Obligation Insured Curves



Source: Altman Investment Management Research and Bloomberg

EXHIBIT IV

Long Term Municipal to Treasury Spreads



Source: Altman Investment Management Research and Bloomberg

Our taxable interest rate strategy forecasts that the yield level for the 10-year U.S. Treasury bond will remain in place, with the potential for short-term set backs. We have identified several factors burdening Treasuries and capping any significant upside for government bond yields. First, the Euro-zone crisis continues to represent a risk for the U.S. economy. Second, ongoing household de-leveraging still poses significant obstacles, as do structurally higher unemployment and the looming "fiscal cliff". Third, with the extension of Operation Twist, the Fed remains in expansionary mode. Keep in mind that over the longer-term, Treasury yields are likely to move higher with more clarity on both the Euro-zone debt crisis as well as the pending structural economic obstacles in the U.S.