Altman Investment Management

Fixed Income Strategy Highlights — February, 2009

Written By: *Peter J. Altman, President*
Jeffrey S. Baumann, Managing Director

Altman Investment Management

34 Chambers Street
Princeton, NJ 08542
609.252.0048
paltman@altman-investment.com

THE U.S. FIXED INCOME MARKET OVERVIEW

- The bond market started the New Year with some positive momentum despite the onslaught of downbeat economic news. In fact, spreads have narrowed across the board since late December, mildly offsetting a fairly dismal '08 performance for all fixed income sectors except Treasury bonds (see Exhibit I on page 2).

- Sustaining a rally in the credit markets, however, might be challenging given that the underlying fundamentals continue to weaken. Market conditions will ultimately key off of balance sheets, risk appetites and sentiment – all of which continue to be tenuous, at best. For example, the January monthly labor report showed that the unemployment rate had jumped to 7.2% – a 16-year high – and that total job losses in 2008 were the largest since 1945. Additionally, severe constraints in bank lending and no access to the capital markets are poised to push high yield default rates much higher this year, from about 4% to the 10% to 12% range, by our estimate.

- While improved financial conditions will help reverse economic weakness over time, more discouraging data is likely in coming weeks. Indeed, near-term economic headwinds, deflation concerns and safe haven sentiment are likely to limit any substantial backup in benchmark government yields. There has been much speculation that the outsized fiscal stimulus plan ready to be signed by President Obama and the ballooning Federal Reserve balance sheet might cause Treasury yields to spike as debt auctions increase in size and frequency. After all, we believe trends such as higher unemployment rates, slower consumption expenditures and deflation risks will trump supply concerns in determining the direction of risk-free rates.

- Treasuries, however, should start to under perform spread products as markets begin to discount a broader bottoming process in the economic cycle. Besides a sell off in government bonds, other preconditions include further narrowing in key short term relationship spreads, much lower daily volatility and more spread compression in the asset-backed and corporate bond arenas.

- One of the most encouraging signs we've seen of improved conditions is the recent opening of the primary calendar. Indeed, new issuances for government bonds and investment grade corporate debt were very active right out of the gate this year, with about $95 billion of new issuance through the first week of the month.

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HIGH GRADE CORPORATES

- 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 bleak 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 482 bps 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.

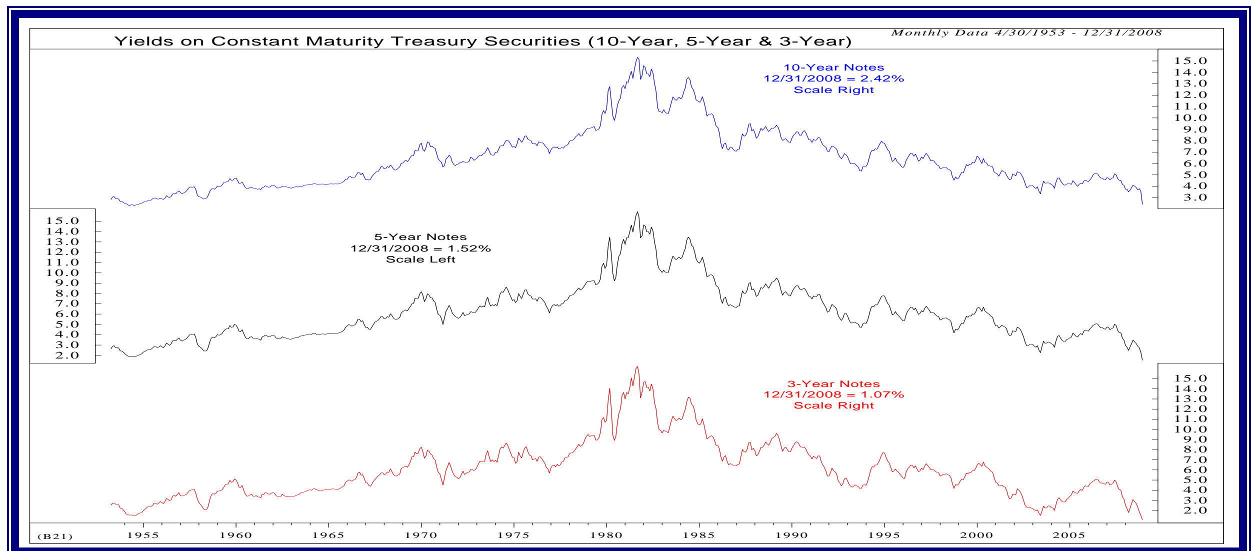
- We recommend keeping duration short for the time being, with maturities ranging from one to ten years. Financials still trade cheap to industrials and utilities, but we like companies that have a combination of the following characteristics; strong free cash flow, large cash balances or access to credit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

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.

EXHIBIT I

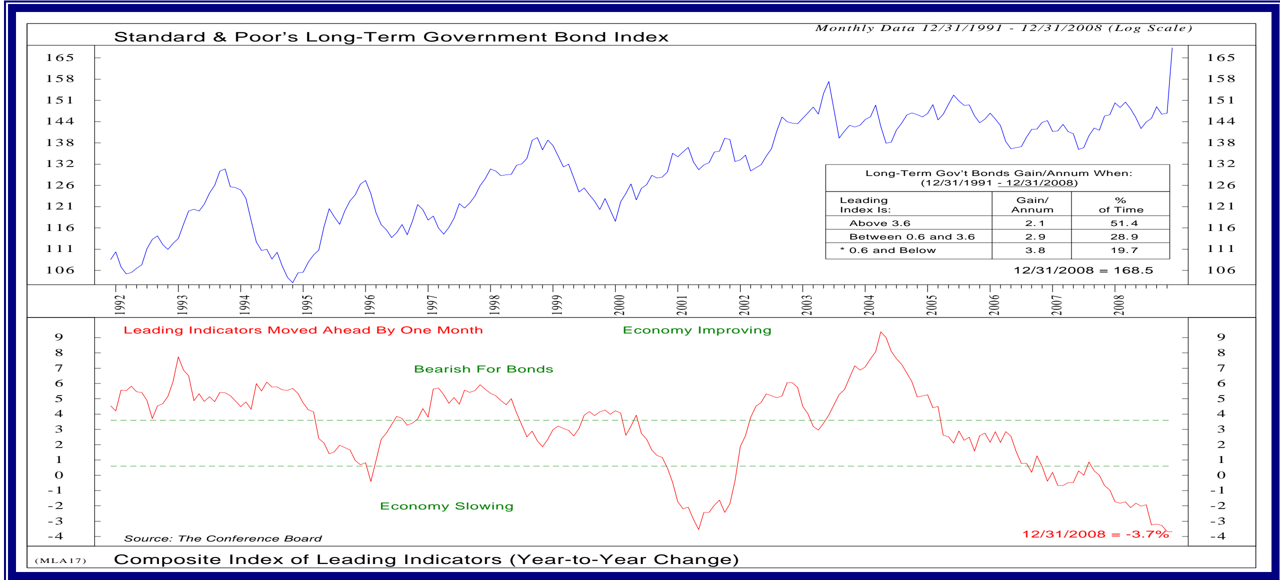


Source: Ned Davis Research

CREDIT CONCERNS

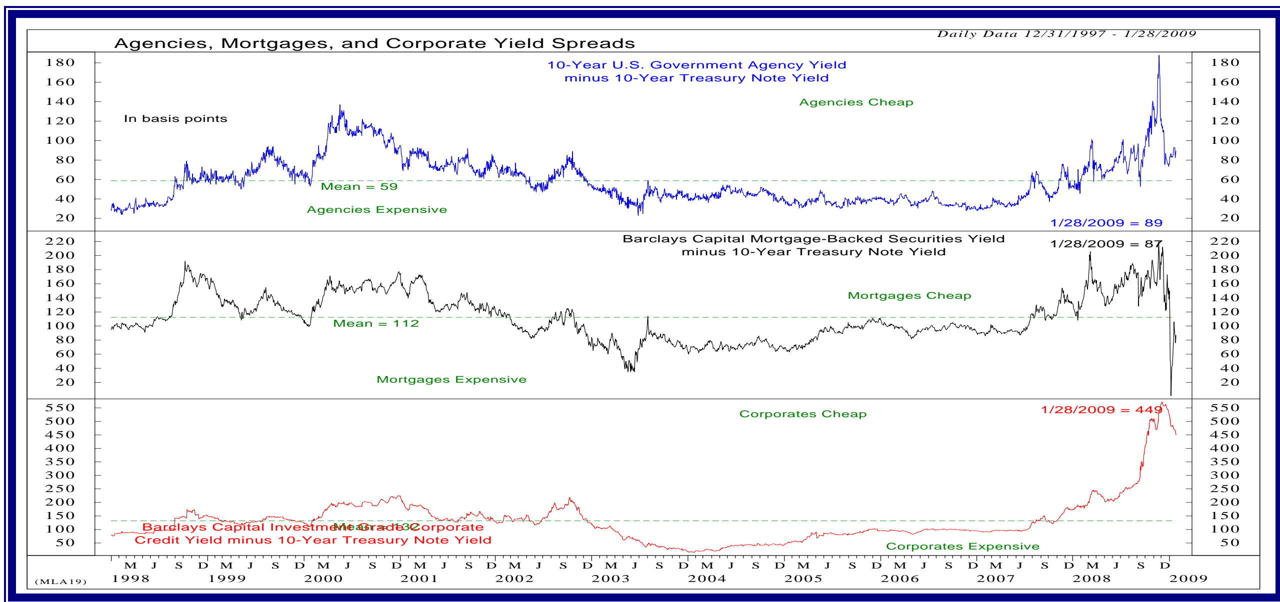
- Federal Reserve policymakers lowered the target rate in the end of October by another half point to 0 to .25% and kept it there in January. Rapidly fading inflation pressures and especially harsh financial conditions suggest considerable scope for additional accommodation as well as further aggressive fiscal steps. Collapsing consumer confidence continues to reinforce the economic downturn, with labor market weakness deteriorating. The failure to stabilize financial conditions could introduce more severe tail risks of debt deflation. See Exhibit IV for the Lead Indicators graphed against the Standard & Poor's Long-Term Government Bond Index.

EXHIBIT II



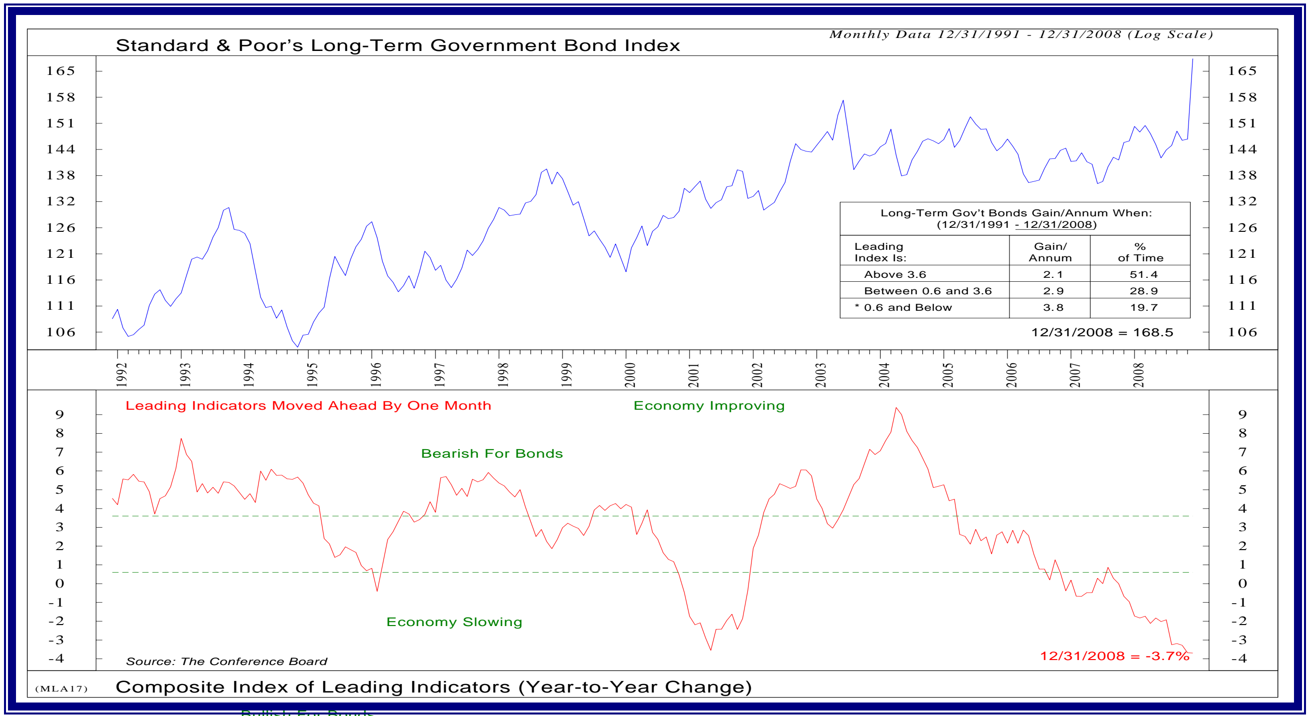
Source: Ned Davis Research

EXHIBIT III



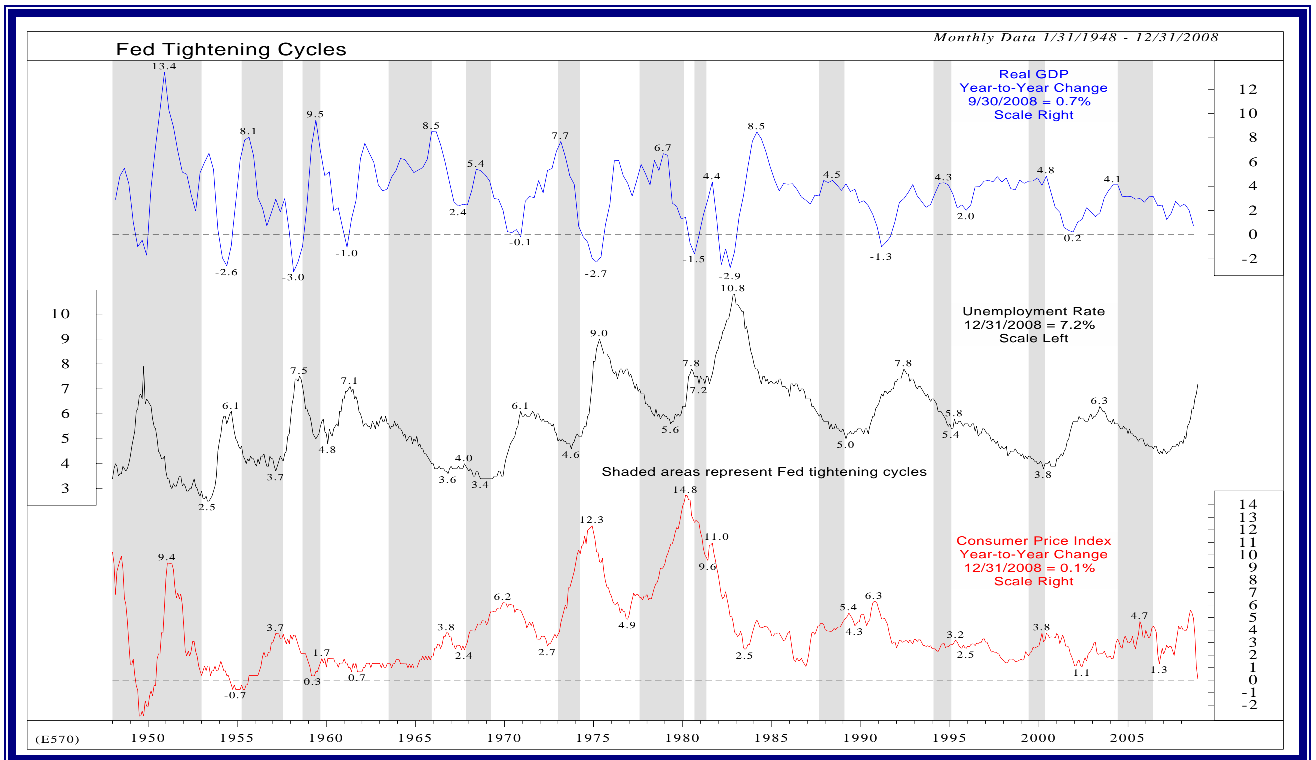
Source: Ned Davis Research

EXHIBIT IV

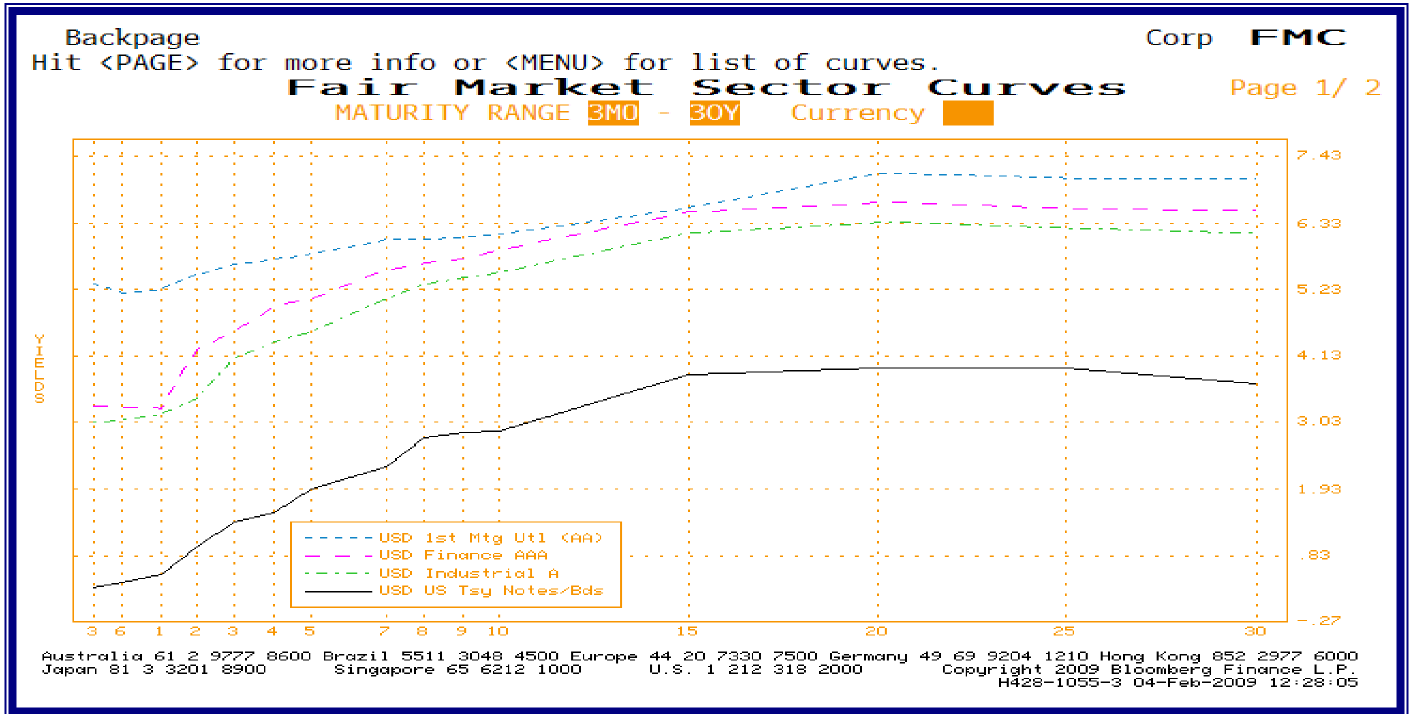


Source: Ned Davis Research

EXHIBIT V



Source: Ned Davis Research



Source: Bloomberg

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