FIXED INCOME STRATEGY HIGHLIGHTS

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THE U. S. FIXED INCOME MARKETS

Brief Overview

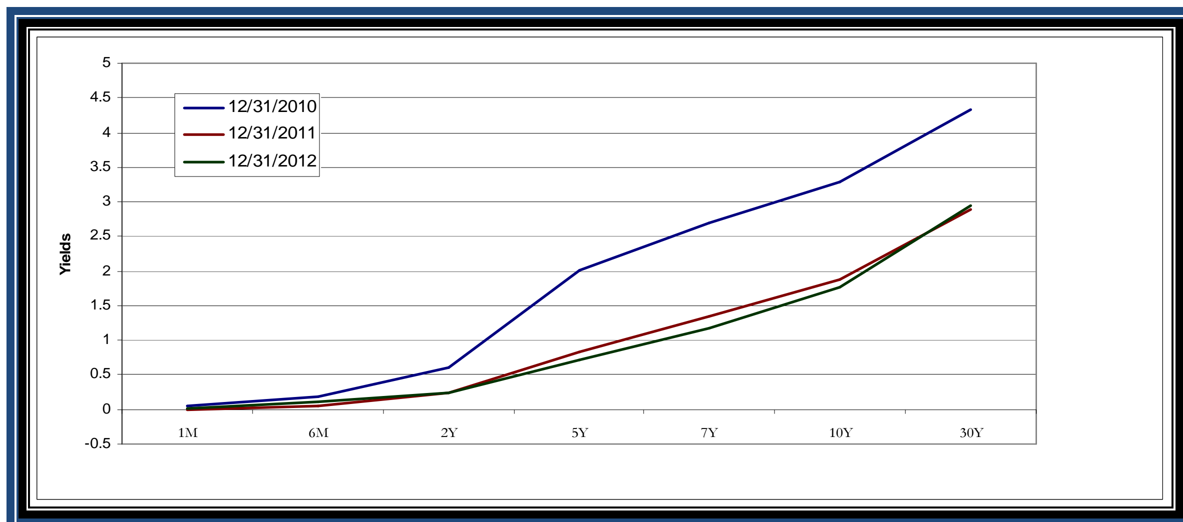
On January 16th, the Federal Open Market Committee (FOMC) released comments that contained minimal policy changes and minimized the weakened Q4 GDP report, saying that "growth in economic activity paused in recent months, in large part due to cuts in defense spending, weather-related disruptions, and other transitory factors." Despite the agreement to avoid the fiscal cliff and the subsequent agreement to postpone the debt ceiling until mid-May, the inability of fiscal policymakers to take significant fiscal decisions prior to the last minute has distorted economic activity and clouded the near-term outlook. However, the committee seems to agree that most leading indicators point to a healthy private sector and suggest that the U.S. economy has not lost momentum.

Growth in 2013 remains dependent on several factors: the effect of higher taxes, reduced disposable income, how fiscal policymakers deal with the sequester cuts scheduled for March 1, and the continuing resolution to fund the government, which expires on March 27. We maintain our forecast of 1.8 -2.0% growth in the first quarter of 2013 and note that downside risks to growth this year will be attributable to the budget sequestration. Although both political parties are dissatisfied to date with the sequester budget cuts, neither party has so far been able to develop a remedy suitable to both sides.

Against this backdrop, we see very little change to the Federal Reserve policy. Given the ongoing volatility in economic activity, fiscal policy driven uncertainty, and the desire to see a substantial and sustained improvement in labor market conditions, we continue to expect that the Fed will continue to purchase assets. We expect the rate of purchases to taper off in the second half of the year, assuming that growth and labor markets improve.

EXHIBIT I

Active U.S. Treasury Yield Curve



Source: Altman Investment Management Research and Bloomberg

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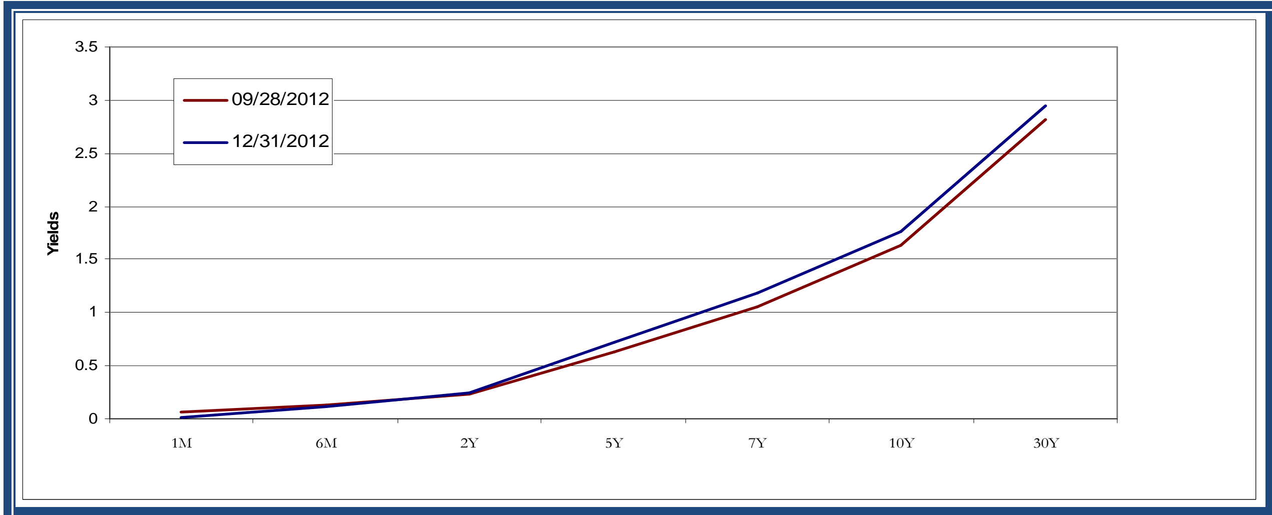
Treasury yields spiked higher the last week in January when data showed banks planning to repay more of the European Central Bank's (ECB) three-year loans than forecast damped demand for safer assets. The yield on the benchmark 10-year Treasury note rose 14 basis points (bps) to 2.01%, while the yield on the two-year note rose two bps to 0.27%, creating a 2s/10s spread of 174 bps which is near the widest since last May. This was the 10-year yield high since April 26, 2012. The yield on the 30-year bond rose 10 bps to 3.13%. The yield difference between the 30-year bond and the two-year note widened to 286 bps. The 2s/30s spread has averaged 223 bps over the past 10 years, according to Bloomberg data.

EXHIBIT II

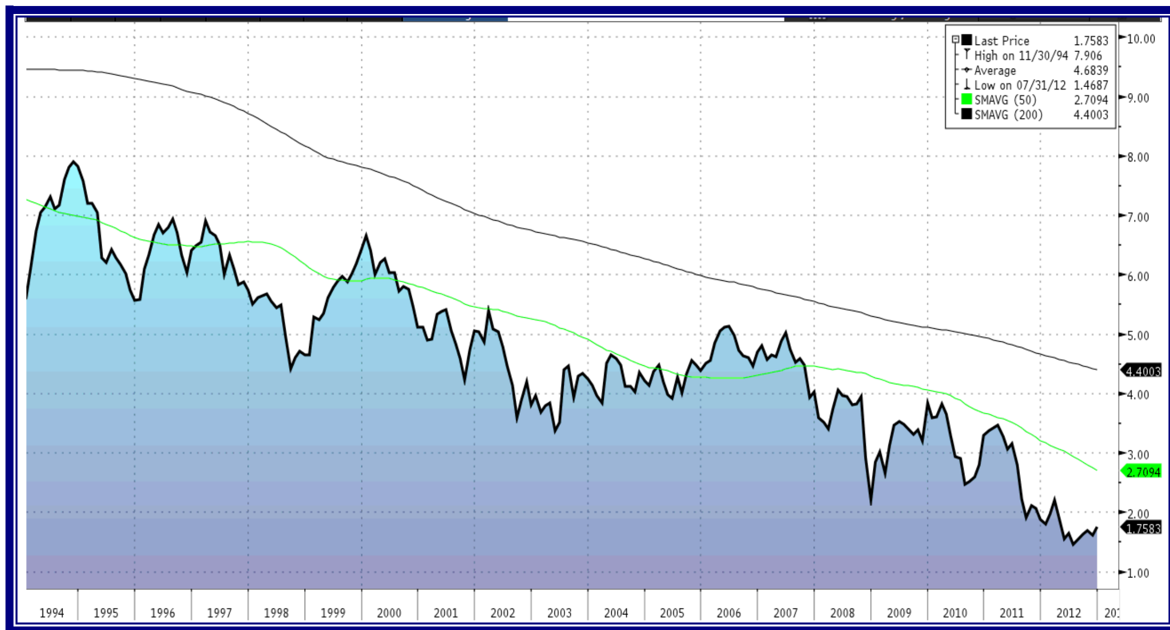
Quarter over Quarter



Source: Altman Investment Management Research and Bloomberg

EXHIBIT III

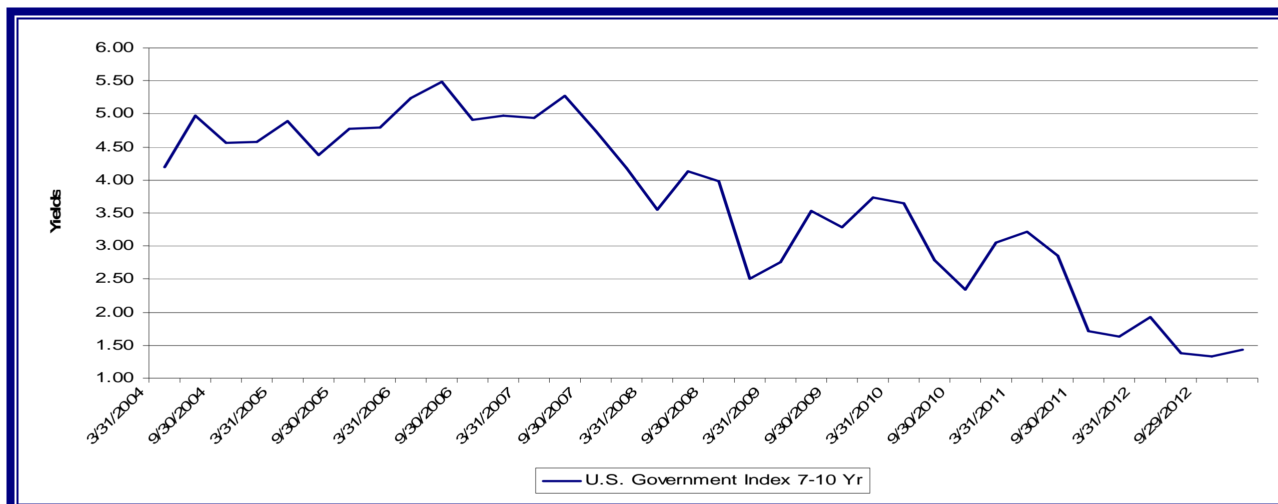
Ten Year Generic Treasury Yield



Source: Altman Investment Management Research and Bloomberg

EXHIBIT IV

U.S. Government Index 7-10 year



Source: Altman Investment Management Research and Bloomberg

In the U.S., we believe the country finds itself in a relatively stronger economic position than it did even a few months ago, which is a key dynamic to consider with regard to fixed income and financial market investment in the year ahead. It is hard to argue against the improvement in U.S. growth, even if it has occurred unevenly, as broad economic indicators, such as consumer confidence, capital goods orders, housing (and autos), new orders/inventories, have demonstrated over the past year. In our view, it appears increasingly likely that U.S. economic growth has turned a corner, although progress may be slow.

The aggressive central bank policy of recent years, and specifically quantitative easing, has been quite effective in achieving certain ends: it has delivered a layer of stability to economies/markets; it has driven much asset liquidity underneath the global financial system; and it has moved prices higher, thereby creating a "wealth effect" that is intended to be self-reinforcing.

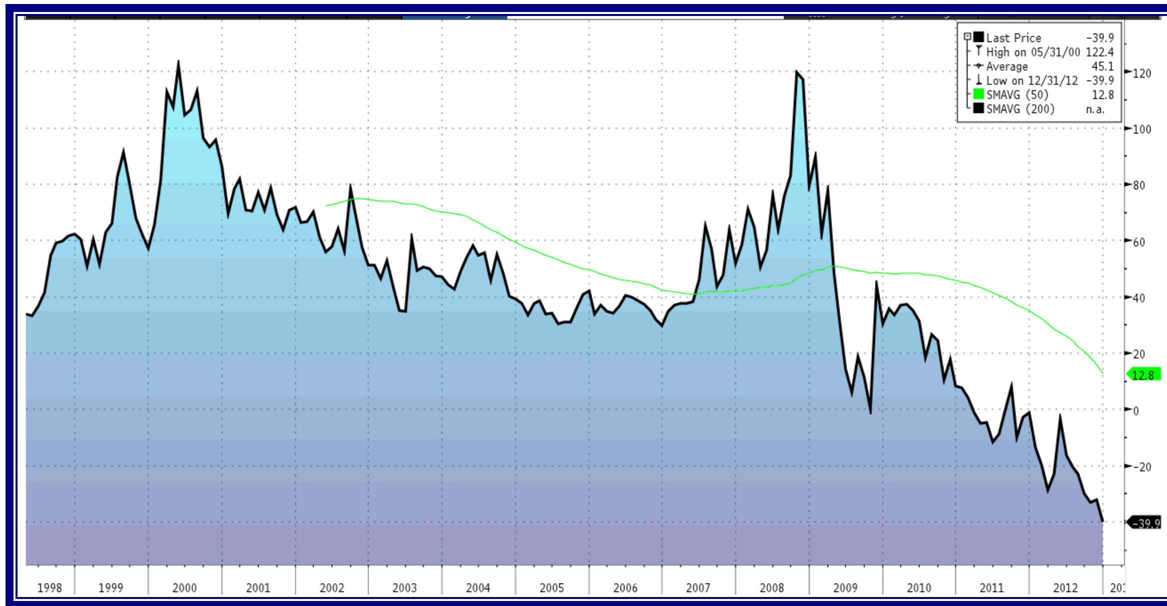
Government Securities

Treasury yields showed little reaction to the better-than-expected jobless claims figures last week, choosing instead to react to Friday's positive European Central Bank (ECB) report. Meanwhile, it is encouraging that Fitch Ratings recently noted that the temporary suspension of the U.S. debt limit removes the short-term risk to the country's current AAA credit rating. Investors appear to be largely neutral or short Treasuries. One-sided positioning, when significant, is typically a contrarian indicator. We stay neutral duration especially since significant selloffs may be followed by a plateau to higher yields, and month-end rebalancing into fixed income is expected to occur; yields will likely remain range bound in the intermediate term.

Looking ahead, we continue to remain neutral on Agency spreads across the curve, as most sectors are currently trading at or near fair value targets. While a temporary suspension of the debt ceiling should be supportive of risk-on trades in general and, as a result, of Agency valuations as well, further significant spread compression in the Agency market is unlikely in our view. This is because Agency spreads versus Treasuries are already trading at the richer end of their historical range across various maturities. As a result, the additional financing costs from overweighting Agencies versus Treasuries appears unattractive, as very little spread widening would completely offset the gains from the spread pickup.

EXHIBIT V

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



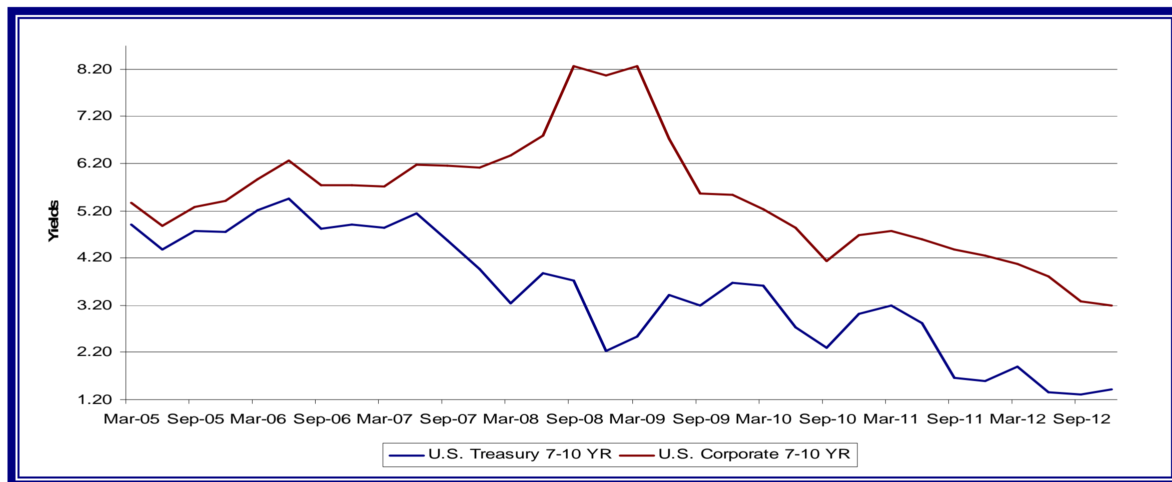
Source: Altman Investment Management Research and Bloomberg

Corporate Securities

Looking forward, the improvement in equity market performance is reasonable given the alternative return potential on bonds, as the expectation that economic growth picks up over the year and some corporate activity which favors equity holders over bond holders. Still, S&P 500 EPS looks like it will come in near $27/share this quarter, slightly higher than prior quarters, so the strong stock market rally is, so far, being driven by reduced systemic risk rather than by improving corporate performance. Also, the Fed is set to buy almost all the net supply of U.S. fixed income. Our view is that equities will outperform credit in 2013 – it's hard for this not to happen if our improving growth forecast proves correct given the low starting point for bond yields.

EXHIBIT VI

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



Source: Altman Investment Management Research and Bloomberg

We still expect that High Grade (HG) credit will have a moderate year with excess return performance of 2-4% over Treasuries in 2013, driven by about 30bp of spread tightening over the year (to our target of 125bp vs. 155bp today) plus the carry. This is not exciting compared to the prior four years of greater than 10% return, but we believe HG credit investors do not expect double digit total returns. We believe the demand from insurance companies, pension funds, sovereign wealth funds and other traditional HG investors will remain intact, and a shift to equities does not mean a total shift away from HG credit for the important holders of the asset class. This view is supported by the strong demand for new issuance over the past two months, even as return performance was modest.

Municipal Securities

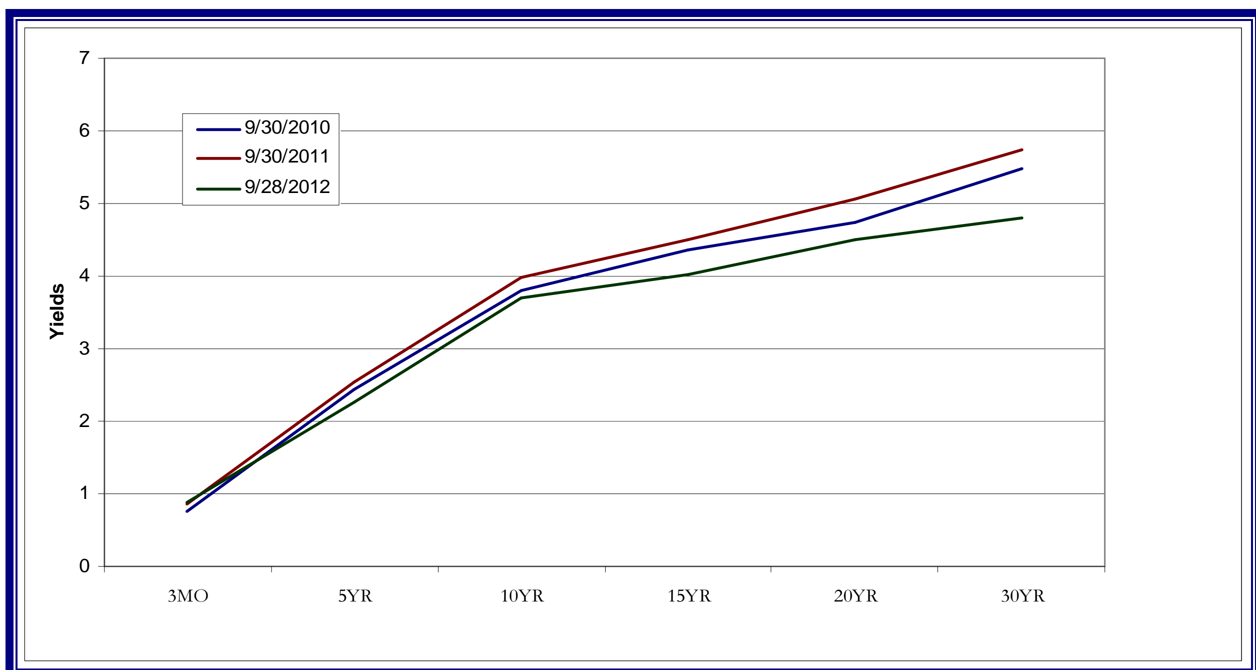
Municipals narrowly outperformed Treasuries with 10-year high-grade yields rising by 8bps versus a 10bps increase in Treasury yields. Municipal bond funds recorded $871mn of inflows recently with all major categories seeing positive flows. Modest leverage (1:1 leverage) in the 9yr sector of the yield curve is projected to earn 220bps above the return on an unlevered position in 30yr HG assets.

The importance of credit analysis has intensified over the last five years as yields and overall rating quality have fallen. AAA issuance has fallen from 56% of primary market supply in 2007 to just 11% today, largely due to the decline in the use of insurance, while AA and A rated bonds have risen by 25% and 12% of annual issuance, respectively. We are able to identify available improved yield opportunities by breaking down the market into the subcategories of the investment grade universe for coupon bonds, zeros, and housing bonds.

Our positioning remains neutral, though with an optimistic bent. We will use market corrections to put some cash to work at attractive levels, while retaining dry powder to take advantage of opportunities that may present themselves in new issuance later in the quarter. After a very strong two-year run, we are focused on income over total return in 2013, and believe selectivity will be key to generating performance.

EXHIBIT VII

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



Source: Altman Investment Management Research and Bloomberg

EXHIBIT VIII

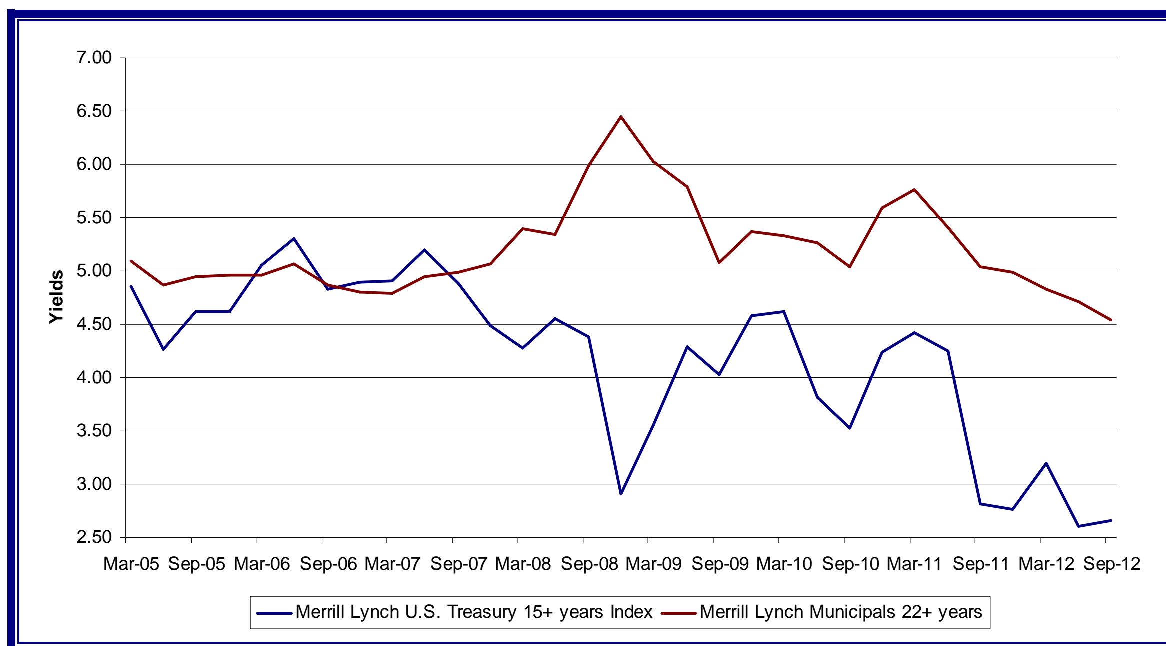
Fixed Income Sector Performance – 2013

Fixed Income Sector Performance – 2012 YTD Sector	Rating	Maturity	Duration Mod Adj	Yield	Spread	Price Spread Avg	2012 Total Return
Treasury	Aaa/AAA	6.47	5.32	0.94%	N/A	$106.27	1.78%
Agency	Aaa/AA+	5.19	3.92	1.11%	26	$106.17	2.54%
MBS	Aaa/AAA	5.44	3.82	2.51%	56	$107.16	1.92%
Municipal	Aa3/A+	13.65	6.52	2.09%	N/A	$108.69	5.84%
Corporate	A2/A-	10.46	7.10	2.80%	137	$112.37	8.33%
High Yield	B1/B	6.68	4.04	5.62%	451	$106.07	15.30%

Source: Altman Investment Management Research and Bloomberg

EXHIBIT IX

Long Term Municipal to Treasury Spreads



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