



Bradford & Marzec

CONTRACTS		CURRENCIES		TREAS	
32	10.0000	5.21	-0.1750	2 YR	99 23/32
32	4 11/32	2384	-0.0005	3 YR	99 6/32
		2248	0.0049	5 YR	98 8/32

## Investment Outlook & Portfolio Strategy

August 11, 2010

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# Economic Outlook

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August 1, 2010

## **Global: Slowdown in China, continued European problems and impact on the U.S. remain the focus.**

- Recent concern over a Chinese slowdown has been allayed as strong 2Q imports continue to reflect robust internal growth. Imports from America slowed significantly reflecting a changing mix of China's imports.
- Increasingly, economic data from Europe is looking better than forecast, although Eurozone growth is still likely to be unchanged (0%) in 2010. Strong exports caused in part by the weaker Euro have buoyed growth. Across the board, necessary spending cuts (e.g. In UK, Germany), however, will continue to present headwinds but, at the same time bring about improved budget deficits. Increases in sales taxes (VAT) will also challenge consumers.
- Despite recent strength the Euro continues to be vulnerable from a technical and a fundamental standpoint. It is approaching a natural 50-60% correction of its recent downtrend and has not broken its 200 day moving average (1.3585 \$/€@7/29/2010) so it could resume its long term deterioration. Significant structural imbalances remain within the EMU and will not be resolved overnight.
- Other large economies such as Japan and Brazil are also likely to slow. The Brazilian Central bank announced that there would be no more rate increases due to the slowing economy. Japan's unemployment continues to rise while industrial production fell the most in June for 12 months. The Baltic Dry index has also been weak, implying lower global demand for bulk dry shipping, a good indicator of slowing world trade.

## **Domestic: Weak U.S. employment data and higher real estate office vacancies imply challenges ahead for U.S. economic growth.**

- U.S. growth for 2Q 2010 slowed unexpectedly to 2.4%. This is sub-par given the depth of the recession. Recent data continues to support a sluggish growth scenario buoyed by strong profits reported in the latest earnings season. The Fed's beige book paints a less rosy and increasingly pessimistic outlook, citing that the economy's future looked 'unusually uncertain'.
- U.S. office vacancies in the second quarter rose to the highest level since 1993 as corporate tenant demand remained sluggish.
- Evidence of a soft patch in the U.S. recovery continues to grow with retail and housing surveys still weak following the end of the Government mortgage subsidies. Retail sales in May fell 1.2% unexpectedly, marking the first decline in eight months. So far in July sales are down month-to-month but ahead by 2.8% over the same period from last year. Service industry growth in June was also less than expected.
- On a more positive note, lower long-term U.S. yields are ultimately expected to provide significant stimulus to the slowing U.S. economy. The 30 year bond yield remains close to 4%. Longer term there is a close correlation between house prices and nominal GDP in the US. Therefore housing needs to recover before any meaningful growth momentum is likely.

Note: Statements expressed are our current opinions as of the date indicated above and are subject to change without notice.

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# Portfolio Strategy- Duration & Yield Curve

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August 1, 2010

**Concern about the Euro as well as economic uncertainty has driven investors to the U.S. dollar and to U.S. treasuries, pushing long-term interest rates significantly lower. This global 'flight to quality' allays fears concerning the oversupply of treasuries for the time being.**

- With the July rally in bond prices the yield curve continues to flatten. However, the curve is likely to remain steep throughout the remainder of the year.
- With the U.S. economy slowing, the Fed is unlikely to begin tightening until well into 2012.
- A more strategic short is possible at some point but is not likely until the economic outlook in the US becomes clearer. 2011 tax increases remain a huge concern at this time.
- Heavy treasury issuance is being met with strong demand which is likely to keep U.S. long-term rates low for the time being. As the economy hits a slow patch, inflation pressures also continue to wane globally making treasuries attractive in these times of uncertainty.
- Looking farther ahead, massive fiscal imbalances in the U.S. will ultimately push long-term interest rates higher. The market will inevitably become saturated with U.S. treasuries and eventually an appetite for risk will direct capital away from 'safe', low yielding assets. In that event, a strategic short duration would be considered. Our stated philosophical range is +/- 25% of the index.

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# Portfolio Strategy- Governments & TIPS

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August 1, 2010

## **Governments: still underweight.**

- Currently underweight both the U.S. Treasury and Agency debenture sectors given better relative value in other higher yielding sectors.
- With average yields around 1.77%, we find little upside potential in U.S. Treasuries.
- U.S. Treasury supply expected to be heavy, but should be absorbed by current 'flight to quality' and demand for dollar assets.
- The conclusion of the Fed's agency purchase plan will hurt demand, but spreads should remain firm on limited supply.
- The fate of the agencies remains uncertain as the administration and congress fail to address the GSE's future.

## **TIPS: no allocation.**

- Sector is out of favor as deflation will be a larger concern than inflation in the next six months.
- Breakeven inflation rates have collapsed following modest inflation releases and strong rally in nominal U.S. treasuries.
- Rent component of CPI continues to drag down headline inflation; core CPI has fallen from 1.8% to 0.9% year-to-date.

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# Portfolio Strategy- Structured Products

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August 1, 2010

## **Mortgages: continue to be underweight.**

- Currently underweight agency mortgages given better upside potential in other risk sectors.
- However, strong investor demand and attractive relative value should continue to support non-agency MBS.
- The recent 'flight to quality' following the European debt crisis has benefited agency MBS.
- Refinancing risk remains muted given the tighter lending standards and negative home equity.
- Currently overweight conventional 30-year mortgages over 15-year to increase yield.
- Recommend higher coupon mortgages as an attractive short duration asset with little refinancing risk.

## **ABS: underweight; little upside.**

- Current ABS valuations leave little upside potential, but should remain firm given strong investor support.
- Fundamentals in consumer-related finance are showing early signs of reaching a bottom.
- Weakness in the labor markets will continue to weigh on credit card, auto, and student loan ABS.

## **CMBS: remain overweight despite Europe.**

- Remain positive on CMBS despite recent sell-off due to the European debt crisis.
- Expect sector to bounce back based on strong relative value and a reduction in overall market volatility.
- Commercial real estate fundamentals reaching a bottom – early signs include improved transaction volume and stabilizing prices.

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# Portfolio Strategy- Investment Grade Credit

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August 1, 2010

**Maintain Overweight. Valuations are very attractive considering the combination of a modestly supportive macro-economic environment, improving corporate earnings, and conservative corporate balance sheets. We believe the attractiveness of Investment Grade Credit was witnessed in July as the U.S. Credit Index returned +1.96% versus -5.24% for the S&P 500.**

- Fundamentally, despite the current soft patch, the gradual growth of the U.S. economy and strong initial readings on second quarter earnings support corporate credit. Modest revenue growth and tight expense control should lead to further expansion of corporate margins. Companies have termed-out their debt maturities, meaningfully improved their short-term liquidity, and have continued to reduce financial leverage. Importantly, financial institution profitability should continue to recover, irrespective of new financial regulations, as credit losses have begun to moderate.
- Technicals have strengthened lately as the market has received better transparency regarding U.S. financial regulation, European banking system risk, and second quarter earnings. Also, through June, investment grade corporate bond issuance has been down 20% versus the same period last year as corporate financing needs have been diminishing. On the negative side, low absolute yields and concerns regarding European growth and the Euro weighed on the corporate bond market.
- Valuations are attractive. Corporate spreads are still well wide of long-term averages and are in-line with spread ranges of the prior two recessionary periods (1991 and 2001).
- We favor companies with improving operating trends, solid balance sheets, and showing a commitment to reducing leverage. We favor Financials as valuations do not seem to reflect the fundamental improvements in earnings, asset quality, and capital ratios. Also, we favor cross-over credits and BBB-rated bonds, as we believe quality spreads will continue to compress.

**Overweight:** Banks, Insurance, Non-Captive Finance, Electric Utility Holding Companies, and REITs.

**Underweight:** Single-A industrials, Consumer Discretionary, Pharmaceuticals, and Yankee Sovereign-related securities.

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# Portfolio Strategy- High Yield

August 1, 2010

## Strong fundamentals and attractive yields position high yield well for the remainder of 2010

- The Citigroup BB/B ex-split B/CCC Index posted a solid 3.44% positive return in July -- bringing year-to-date performance to an impressive 7.59%. Investors flocked back into the market after the April/May sell-off in the search of income and return. High yield is positioned relatively well given multi-year low yields across most other fixed income asset classes.
- Corporate earnings continue to impress thus far in the second quarter, with top line revenue growth and profits continuing to beat estimates. Strong cash flow generation continues to enhance balance sheet strength as corporations continue to reduce debt and build cash balances. Corporate executives are becoming somewhat more upbeat, but remain reluctant to increase their leverage given numerous macro uncertainties -- a positive for bondholders.
- Roughly \$2.8 billion flowed into high yield mutual funds in July, the largest inflow since April 2009. Year-to-date inflows now total over \$3.1 billion. High yield inflows have significantly lagged higher quality fixed income asset classes year-to-date. This fact, combined with high yield's strong underlying credit fundamentals and attractive relative yield lead us to believe that inflows will remain healthy over the remainder of 2010.
- Global high yield default rates (Moody's 12 month trailing) fell again in July to 5.5% from their peak of 13.5% last November. Rating agencies are responding to all the positive news with upgrades significantly outpacing downgrades in 2010. These trends support gains in high yield.
- High yield primary market activity picked up significantly, with July's \$20 billion in issuance exceeding both May and June combined. Year-to-date issuance stands at \$152 billion; still on pace to eclipse last year's record \$180 billion. Refinancing remains the key driver of issuance, accounting for 70% of new deals year-to-date. Corporations have made great strides over the past year in stabilizing their balance sheets by reducing leverage and extending debt maturities.
- We are currently taking profits in select outperformers following the recent rally and swapping into higher yielding credits that possess stable to improving fundamentals. Given our outlook for subpar U.S. economic growth we remain underweight most consumer cyclical industries, but we do find value in a few cyclical industries such as autos, airlines and paper. We continue to find value in smaller issuers that fall below the radar of larger managers and offer incremental yield. We still expect yield/income to be the key driver of portfolio performance in 2010.
- Merger and acquisition activity should increase going forward, but we believe that most deals will be smaller in nature, conservatively financed and driven by larger/higher rated companies looking to grow revenues.

**Overweight:** Autos, banking/finance, energy, gaming, insurance, paper/packaging, REITs, technology, telecommunication, transports

**Underweight:** Building materials/housing, chemicals, electric, food/beverage/tobacco, healthcare, media, finance, restaurants, supermarkets

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# Portfolio Strategy- Non Dollar

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August 1, 2010

**Risk is back in – for now – as EU stress tests calm markets despite questionable scenarios. Dollar buffeted by low U.S. yields, as Fed on hold and U.S. data weak. Dollar bloc bonds and gilts remain in favor.**

- Risk seeking replaced risk aversion as EU stress tests revealed only seven banks – 5 in Spain (savings banks or cajas), 1 in Greece (state-owned), 1 in Germany (state-owned) – require capital infusion of 3.5 billion euros in total. While most of recovery in currencies was short-covering, new positions have been initiated.
- After a downturn at the start of July, risk currencies, especially the Australian dollar, gained back up to 75% of May losses as European concerns and Chinese growth doubts have reversed. Chinese data revealed a “Goldilocks” scenario where growth is just right and inflation is lower than expected, thereby stalling any imminent rate increase by the PBOC, the Chinese central bank. The Aussie dollar has been boosted by a more favorable iteration of the pending mining tax and the expectation that the RBA, Australia’s central bank, will raise rates at its August meeting in response to new consumer price data. The RBNZ, New Zealand’s central bank, just raised their rates as expected despite the recent mixed economic data; however, their accompanying dovish statement adjusted market expectations lower. We maintain our positions out the curve in Australia and New Zealand sovereign bonds, as yield spreads remain attractive. Bonds are fully hedged as the currencies, more correlated with general risk sentiment than with country-specific fundamentals, are in full whipsaw mode.
- Canada now shares the safe haven category with the U.S. and attracted a record volume of foreign purchases in the latest release. The BOC, Bank of Canada, also data-dependent, is expected to continue in its rate hike mode, albeit at a slower pace.
- Due to a budget-friendly, U.K. electoral outcome, we continue to see upside in the gilt. Recent dovish comments by the Bank of England regarding deflationary fears have further supported gilts. Spreads remain attractive versus European bonds despite the lower U.K. risk given the U.K. absence from the bailout packages and rating agencies have affirmed the ‘AAA’ sovereign rating of the country.
- Despite “tranquility” imparted to the market by the bank stress tests, European economic conditions remain mixed, hampered by the massive bailout packages and their negative impact on growth. Greek budget difficulties could spread to other peripheries, especially Spain. The euro is currently buoyed by the low yielding U.S. dollar assets; however, European growth depends on a weaker currency to increase exports. The ECB is still reluctant to raise rates due to growth concerns.

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# Benchmark Performance – As of July 31, 2010

August 1, 2010

<u>Benchmark Performance</u>	<u>MTD%</u>	<u>YTD%</u>
Barclays U.S. Aggregate	1.07	6.46
Barclays U.S. Treasury	0.68	6.58
Barclays U.S. TIPS	0.14	4.56
Barclays Investment Grade Corporate	1.96	7.87
Barclays U.S. ABS	1.24	6.12
Barclays U.S. MBS	0.86	5.35
Barclays U.S. CMBS	2.12	14.51
Citigroup High Yield BB/B (excluding split B/CCC)	3.44	7.59
Citigroup Non-U.S.\$ World Government Bond (50% hedged)	2.71	2.36
	<u>Jun 30</u>	<u>Jul 31</u>
10-Year U.S. Treasury Yield	2.95%	2.91%

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