



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

January 2012

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# Summary of Economic and Sector Outlook

January 2012

## Economic Summary and Outlook

### ▪ Global Economies (ex U.S.)

European concerns continue to temper optimism over better-than-expected economic data outside of Europe. China shows signs of slowing but action by authorities could bolster economic activity.

### ▪ U.S. Economy

We remain cautiously optimistic as U.S. economic data continues to improve. While high unemployment, a tenuous real estate recovery, political dysfunction and a European recession all pose risks to growth, the fourth quarter produced data that suggests a recovery is underway. We expect 1H12 U.S. GDP growth of above 2.0%.

## Portfolio Strategy

### ▪ U.S. Government

We are underweight U.S. Treasuries and agencies as we see little value in the sector. The Fed's Operation Twist program will absorb most 30-year and 10-year supply, keeping long term rates low. We see low inflation risk and are avoiding TIPS.

### ▪ Structured

Agency MBS is supported by favorable supply and demand, attractive valuations, and incremental clarity on government refinancing plans. High-quality non-agency mortgages offer attractive yields and strong relative value. We are positive on CMBS, but have become more defensive in the short term given the macro uncertainties and market volatility.

## Portfolio Strategy (cont'd)

### ▪ Investment Grade Credit

We remain overweight due to strong corporate balance sheets, solid earnings, and historically attractive valuations.

### ▪ High Yield

Strong investor demand has been driven by solid credit fundamentals and attractive relative yield. High yield also provides diversification benefits given its low historical correlation to interest rates. We remain constructive on high yield for 2012.

### ▪ Leveraged Loans

We remain positive on loans as valuations remain attractive based on historical levels. We favor loans with LIBOR floors as this segment of the loan universe continues to outperform.

### ▪ Non-Dollar

We favor U.K. gilts over core Europe. We also favor Australia/New Zealand bonds for their attractive yields and Canada for its safe haven status. These three countries offer better economic/fiscal fundamentals than other developed nations. In currencies, we favor Canadian dollar and are neutral on Australian/New Zealand currencies at current levels.

# Global (ex U.S.) Economic Summary and Outlook

January 2012

**Global growth likely to slow but should remain firmly positive. Austerity measures enacted by Greece, Italy, Spain and other countries could weigh on overall Euro region growth. In addition, the GIIPS sovereign crisis remains a significant threat.**

## EUROPE

- Overall, we expect Europe to enter recession in 2012, at least partially due to the effects of higher taxation and further austerity measures in certain countries despite positive growth from Germany. Slowing inflation could allow the ECB to cut interest rates further.
- The Euro ranked as the world's worst performing currency for 2011. The currency decline increases the cost of energy and other raw materials for all euro countries. Unfortunately, the export benefit of the low euro mostly benefits the healthier and more industrialized Northern European economies, rather than the GIIPS sovereign-challenged issuers in the south.
- The GIIPS sovereign crisis remains unsolved with little news flow over the holiday period. Some believe Germany is slowly increasing its influence over negotiations. Meanwhile, Greece faces €14.4B of sovereign debt maturities in March 2012.
- Growth in Germany should slow in 2012, but won't turn negative. Germany's unemployment rate fell to a new low of 6.8%, down slightly from 6.9% in December 2011, partially due to strong exports.
- We expect France to enter recession in 2012. French consumer spending fell 0.1% in October on rising unemployment and uncertainty about the European debt crisis.
- Spain warned that its already grim budget deficit forecast could worsen. The warning was given as the new center-right government prepared the country for more austerity measures designed to reduce spending. Spain's 2011 deficit could increase from 6% of GDP to as much as 8%, if the new estimate of €20 billion in extra costs is correct.

- ECB open market purchases continue to influence yields on distressed European debt. A rise in yield on Italian debt is worrisome given the size of the country's 2012 debt retirement schedule. So far, in the absence of a permanent solution to the GIIPS sovereign crisis, ECB intervention has seemingly prevented a collapse of the European banking system.

## ASIA AND THE REST OF THE WORLD

- We anticipate slightly slower Chinese growth in 2012 (no "hard landing") caused mainly by a European recession which will hamper exports. Property prices in China continued to slide, raising speculation that Chinese authorities may cut the reserve ratio in the near future. As a public policy tool, this is considered to be one of the most effective ways to boost economic activity and will demonstrate that the Chinese are anxious to maintain a robust economy.
- The bond markets of dollar bloc countries of Australia, Canada and New Zealand continue to perform well against U.S. Treasury equivalents, reflecting better long-term fundamentals, falling interest rates in line with slowing growth, and stable to strong currencies. The Australian dollar reached an all time high against the euro.
- Brazil continues to be a bright spot in the world economy and is likely to see growth accelerate in 2H12 to 3.5-4.0%. The pickup is due to lower taxes on some exports and low income housing construction.
- The Russian economy, still in transition from a planned to a market economy, is expected to continue to grow in 2012 with significant spending in infrastructure needed. Toward the end of 2011, Russia achieved a balanced budget, a significant improvement from its -6.0% GDP deficit in 2009. Russia will continue to benefit from development of its rich natural resources.
- Australian economic data continues to beat expectations. Services PMI was reported at 49.0 for December, up from 47.7 in November.

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# U.S. Economic Summary & Outlook

January 2012

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## The U.S Economy Marches On

- With the European debt crisis as a backdrop, the U.S. risk markets largely rallied in December. U.S. high yield and investment grade markets outperformed most risk markets for the month.
- The U.S. economy continues to show improvement with some encouraging data points coming at the end of the year.
- The Department of Labor reported that a seasonally adjusted 381,000 people filed for unemployment benefits for the first time last week. That figure fell to its lowest level since June 2008.
- The ISM factory index climbed to 53.9 last month from 52.7 in November, which marks the fastest rate at which U.S. factories have expanded in six months.
- Consumer sentiment improved in December to its highest level in six months as the University of Michigan's index on consumer sentiment surpassed economists' expectations.
- The National Association of Realtors announced that its pending-home-sales index (a measure of future activity) also rose in November to the highest level in more than a year and a half.
- However, consumer credit increased by \$7.7 billion compared to an expected increase of \$7.0 billion. The data indicate consumers are relying more on credit to sustain spending as income gains fail to keep up with inflation and home price depreciation.
- Deep discounts and late store hours drove consumer spending, lifting U.S. retail sales in November and December above expectations. The top line for retailers may be offset by the aggressive retailer discounting.

## First Quarter Outlook

- We remain cautiously optimistic as U.S. economic data continue to improve. While event risk remains high, we expect 1H12 U.S. growth of above 2.0%.
- In a last ditch effort, Congress passed a two-month extension of the payroll tax. While this should be a positive for GDP growth in the first quarter, Congress must come to an agreement to allow the extension to be passed for the full year.
- U.S. economic data seem to be improving. GDP growth in 4Q11 is expected to be greater than the prior quarter and the consensus economic GDP estimates for 2012 show year-over-year improvement.
- However, high unemployment persists (over 8.5%), the housing market recovery remains tenuous, U.S. consumer debt is elevated, and Europe is poised for a recession. These risks could derail the nascent U.S. recovery.
- Europe's ability to resolve these economic issues in a political arena, involving sovereign nations with cultural differences, will determine the depth of their recession.
- The U.S. enters a presidential election year which unfortunately may put real world solutions on the backburner and political posturing upfront.
- Political dysfunction and fiscal policy in Europe and the U.S. impart major uncertainties to the global economic outlook.
- Nevertheless, we remain cautiously optimistic about growth in the first half of 2012.

# Portfolio Strategy – Governments and TIPS

January 2012

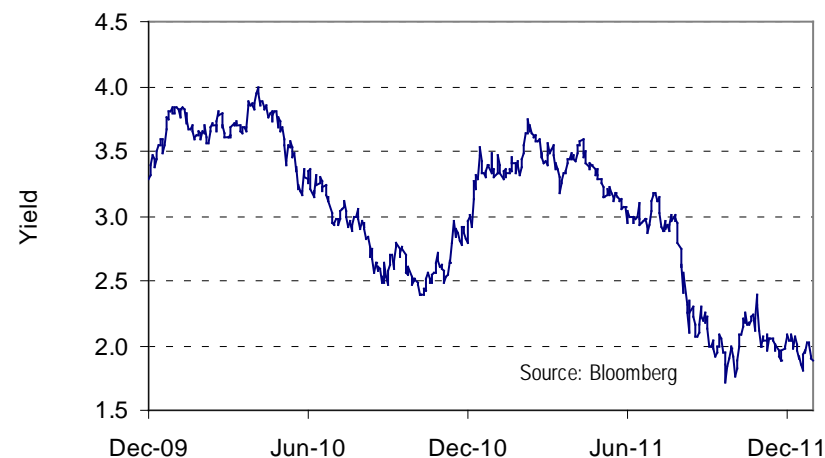
## U.S. Governments: remain underweight

- Little opportunity in the U.S. Treasury or agency debenture sectors given the very low yields available.
- Treasuries retain flight to quality demand due to ongoing European crisis.
- The Fed's Operation Twist will absorb all of the 30-year and most of the 10-year Treasury issuance and keep long rates low in the near term.
- Agency debentures provide little upside potential. Nevertheless, the very low-supply environment should support current agency valuations.
- Losses continue to accumulate at the agencies. The GSE's regulator expects cumulative draws from the U.S. Treasury of \$220 -331 billion by the end of 2014.

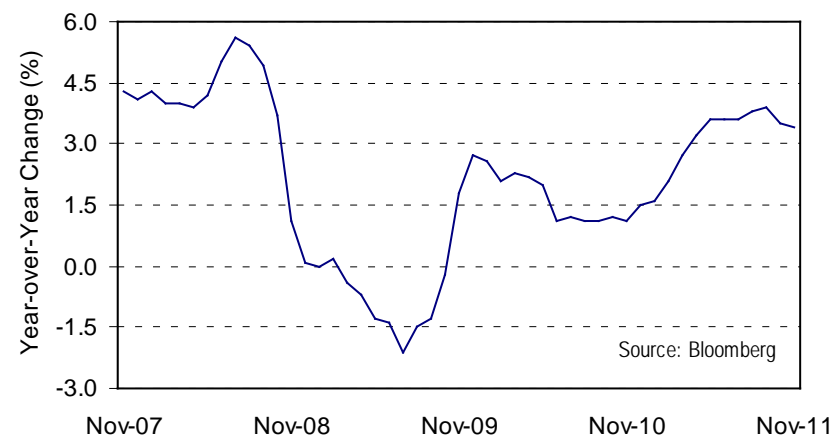
## TIPS: no allocation

- Continue to avoid the TIPS market on outlook for stable to lower inflation in 2012.
- TIPS underperformed in December on poor investor demand and muted inflation reports.
- Breakeven inflation rates finished the month lower at 1.95% with headline CPI reported at 3.4% for November.
- Significant excess capacity and labor market slack in the U.S. economy should curtail pricing pressures.
- Fed purchases of TIPS in Operation Twist should support long-maturity bonds.

### U.S. Treasury 10-Year



### U.S. CPI



# Portfolio Strategy – Structured Products

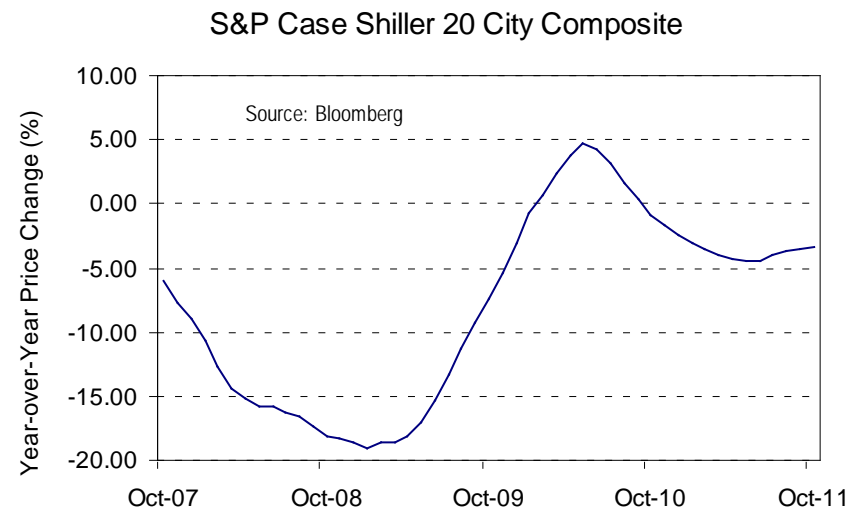
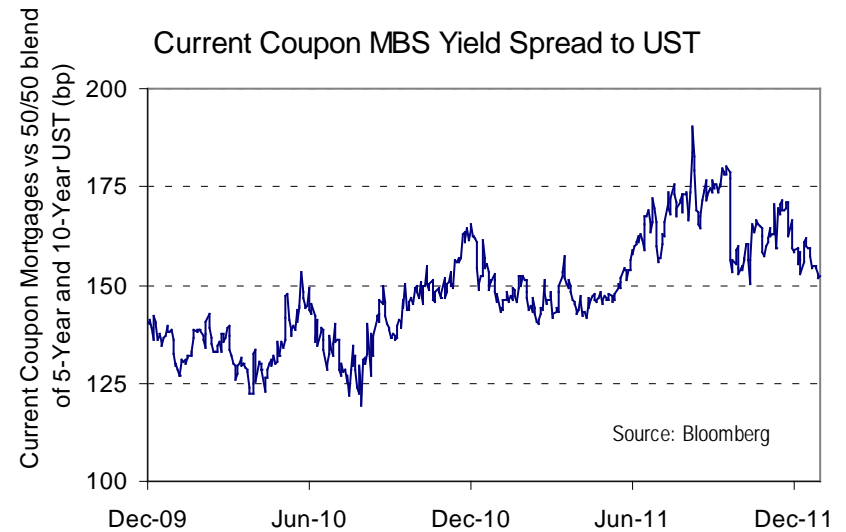
January 2012

## Agency MBS: valuations attractive – add to positions

- Agency MBS modestly outperformed U.S. Treasuries in December on strong investor demand.
- Our positive outlook for the MBS sector is supported by a favorable supply and demand balance, attractive valuations, and incremental clarity on the government refinancing plans. We favor agency MBS with a focus on 4.0% 30-year sector.
- The government streamlined refinancing plan is expected to have a muted impact on the overall mortgage market.
- The Fed's plan to reinvest agency pay-downs into MBS dramatically improves the supply and demand dynamic. We expect \$15-20 billion in monthly MBS purchases from the Fed's Operation Twist.
- Fed officials speak in support of additional agency MBS purchases to support the overall economy and housing market. QE3 represents a potential upside surprise.

## Non-Agency MBS: strong relative value in higher-quality bonds

- We remain positive on high-quality non-agency mortgages due to attractive yields and strong relative value versus other sectors.
- Prices for non-agency mortgages remained stable in December with very quiet trading volumes. Yields for prime fixed-rate non-agency bonds range from 5.0-7.0%.
- Some concerns exist around potential European bank deleveraging and sales of non-agency MBS.
- Latest Case Shiller Housing Price Index shows signs of stability, but the backlog of foreclosed properties remains a concern.



# Portfolio Strategy – Structured Products

January 2012

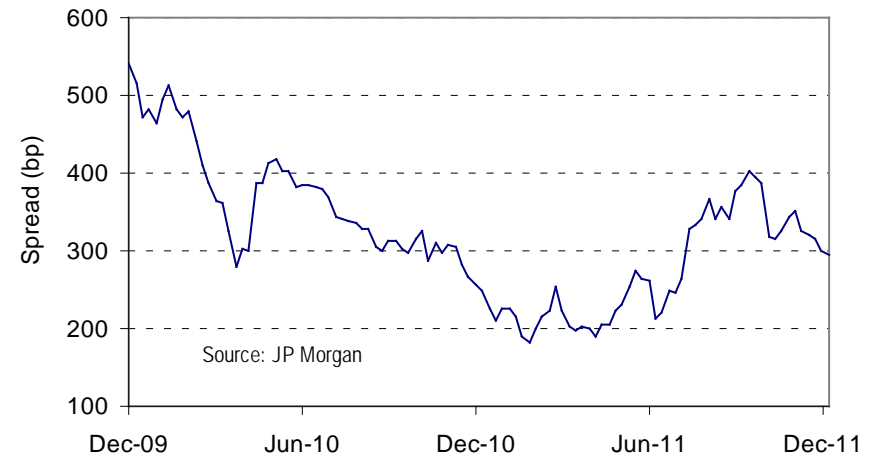
## CMBS: more defensive, but remain overweight

- CMBS outperformed similar duration Treasuries in December on improved investor risk appetite and strong year-end buying.
- We remain positive longer term, but have become more defensive in the short term given the macro uncertainties and market volatility.
- Commercial real estate fundamentals are stabilizing. Availability of financing, a slowing pace of delinquencies, and bottoming prices should provide underlying fundamental support to CMBS markets.
- We favor super senior, last cash flow bonds from new deals and select high-quality 2007 vintages. We also continue to favor 2006 vintage senior mezzanine tranches with strong collateral and loss protection.

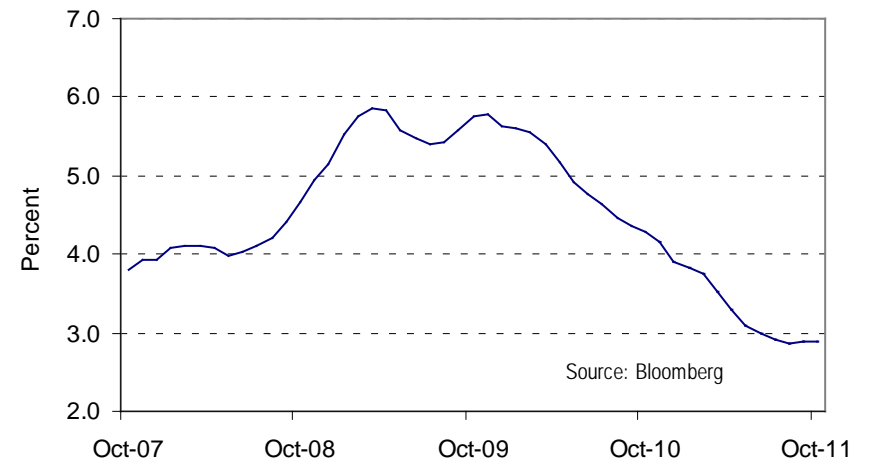
## ABS: underweight; little upside

- Current ABS valuations leave little upside potential, but should remain firm given strong investor support and improving fundamentals.
- Credit statistics across the ABS universe continue to improve as consumers deleverage.

CMBS Aaa Super Sr. Spread to Swaps



U.S. Credit Card Delinquencies



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# Portfolio Strategy – Investment Grade Credit

January 2012

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**We have a positive outlook for IG Credit based on strong corporate balance sheets, solid earnings, and historically cheap valuations. These characteristics should allow IG Credit to perform well in most macroeconomic scenarios.**

- Investment Grade Credit performed well in December on good U.S. economic news and strong investor demand. The Barclays Capital U.S. IG Credit Index posted an excess return of +0.83% relative to similar maturity U.S. Treasuries.
  - Valuations are very attractive on a historical basis. Spreads are higher than observed in the 1991 recessionary period, and near the wide of the 2001 recessionary period.
  - Fundamentally, U.S. industrials are underpinned by conservative balance sheets, excellent liquidity, and healthy earnings. Within financials, the banking industry has record liquidity, strengthening capital bases, and continued improvement in asset quality. These traits should allow issuers to successfully navigate through mortgage-related lawsuits, the evolving regulatory environment, and any effects from the European sovereign crisis.
  - Share buybacks, higher dividends, and M&A activity are likely to continue to be conservatively financed in this volatile market environment.
  - Corporate earnings continue to exceed expectations. Upcoming 4Q11 earnings are expected to be up 15% year-over-year. However, earnings growth is likely to slow in 2012.
- Market technicals have turned positive, as real money buying has driven dealer inventories down to levels not seen since 2003. Unfortunately, spreads should remain susceptible to headline volatility, especially related to the European peripheral countries' debt problems.
  - We favor companies with a commitment to reduce leverage, stable operating trends, and/or solid balance sheets. We favor Financials as current valuations seem much more reflective of headline fears than fundamental balance sheet and economic realities. We also favor cross-over and BBB-rated Industrial credits as we believe spreads on lower rated bonds will converge with spreads of higher rated bonds.

**Overweight:** Banks, Insurance, Energy, Cable-Media, Pipelines, and REITs

**Underweight:** Double-A and Single-A rated Industrials, Pharmaceuticals, and Yankee Sovereign-related securities

# Portfolio Strategy – High Yield

January 2012

## Solid gains in December on firmer economic data in the U.S. and very strong investor demand for yield – higher returns expected in 2012.

- The high yield market rebounded smartly in December, with the Citigroup BB/B ex-split B/CCC Index rising 2.55% following November's 1.68% decline. The Index finished 2011 up a solid 6.83%. Lower-rated bonds outperformed in December as investors reached for yield, but higher quality bonds were the top performers for the year. The top performing industries in December were P&C Insurance, Telecommunications, Cable and Pharmaceuticals. The worst performers were Refiners, Transportation, Banks and Paper/Forest Products.
  - Third quarter earnings per share exceeded expectations again, rising 14% year-over-year as sales rose and margins expanded. The strongest gains were in Energy, Materials and Telecommunications; with Utilities and Consumer Staples posting the smallest gains and Financials' earnings actually down. Corporate executives remain cautious in their outlooks due to numerous macro political and economic uncertainties, but most are very comfortable with their financial position. Balance sheets remain very strong; a growing number of companies are using some cash to buy back stock/raise dividends to boost share prices.
  - High yield mutual fund flows rose with the market in December as over \$3 billion flowed into the market. This brings total inflows for 2011 to just under \$14 billion, marginally above the \$13 billion of inflows for 2010. Mutual fund inflows started 2011 quite strong, retraced to barely positive on the year by the end of the 3Q11 and then surged over 4Q11 (including several of the largest flows ever).
  - The S&P 12-month trailing default rate (issuer basis) through November edged down to just under 2%, the lowest level since early 2008. That being said, there have been a few notable defaults in recent months. We expect default rates to edge modestly higher in 2012, given our outlook for a weaker global economy and continued market volatility. Rating agency actions have also turned more negative in recent months and are likely to be more mixed going forward.
  - The new issuance calendar tapered off into year end, with only \$4 billion pricing in December. New issuance totaled just under \$230 billion for 2011, second only to last year's record of over \$300 billion. The use of proceeds over 2011 remained fairly conservative, with about 55% for straight debt refinancing and only 22% for acquisition/LBO financings. Most issuers will remain very opportunistic in accessing the debt markets in 2012, despite historically low interest rates, as corporate cash levels remain at record highs.
  - We continue to expect that merger and acquisition activity will increase in 2012, as organic growth will remain difficult for many corporations given the expected subpar economic environment. High yield companies should primarily benefit from this trend as they represent attractive targets for cash-rich investment grade companies. That being said, acquisition activity by high yield companies is also likely to increase. Highly leveraged transactions (i.e. LBOs, MBOs) are unlikely as companies remain leery of overleveraging their balance sheets in the current uncertain macro environment.
  - We anticipate domestic economic growth will modestly improve in 2012, but for the Eurozone to weaken and emerging market growth to moderate slightly. Corporate profit gains should moderate somewhat, but cash flow generation and balance sheet strength are expected to remain solid. These healthy fundamentals, combined with very attractive relative yields, will continue to attract investors to the high yield sector. Our strategy is to remain underweight most cyclical industries and focus on those with more stable operating trends and solid balance sheets.
- Overweight:** Diversified Manufacturing, Energy, Financials, Insurance, Paper/Packaging, Pipelines, Technology and Transportation
- Underweight:** Banks, Building Materials/Homebuilding, Chemicals, Consumer Products, Food/Beverage/Tobacco, Healthcare, Industrials, Cable, Retailers/Restaurants and Supermarkets

# Portfolio Strategy – Leveraged Loans

January 2012

## Leveraged Loans Surge in December

- Despite macroeconomic noise, the loan market was relatively stable in December. The Credit Suisse Leveraged Loan Index (CS LLI) was up 0.51% and 1.82% for the month and the full year, respectively.
  - For the month, split BB's (+0.87%) and single B's (+0.82%) outperformed.
  - Loans with LIBOR floors (+0.80%) also outperformed.
- The CS LLI average price at month end moved up to 92.19 in December from 91.88 in November.
- The average nominal spread of loans remained approximately 400 bp and the 3-year discount margin decreased from 669 bp to 656 bp, as a result of price appreciation.
- After demand shifted in the direction of relative-value players during the liquidity-starved third quarter, the investor market for leveraged loans tilted toward banks and traditional accounts over the final three months of 2011.
- Still, the share of the market held by hedge funds, high-yield accounts, and other relative-value players account for over one-third of the demand and remain above levels in the first half of the year.
- Loan fund outflows have been mild and lower than expected in December. Consequently, investors have available cash to put to work. There was a cumulative inflow of \$9.1 billion in 2011 versus \$12.3 billion in 2010. Most of the inflows occurred in the first half of the year.
- The new issue pipeline remains light and is estimated to be approximately \$3.0 billion. Consequently, until the primary market grows, it is our expectation that investors will push secondary prices higher as they put cash to work.
- The lagging 12-month default rate (0.17%) remains well below historical averages.

## Average New Issue Pricing By Rating

	October	November	December
<b>BB/BB-</b>			
Straight Spread	L+408.3	L+335.0	L+315.0
All-in Spread	L+562.6	L+438.7	L+398.0
Yield-to-Maturity	6.0%	4.8%	4.5%
<b>B+/B</b>			
Straight Spread	L+625.0	L+516.0	L+525.0
All-in Spread	L+864.6	L+682.0	L+684.7
Yield-to-Maturity	8.8%	7.4%	7.4%

*S&P LCD Weekly*

## Monthly new-issue volume (\$ billion)

	October	November	December
<b>Monthly</b>			
Pro Rata	10.02	11.45	13.59
Institutional	8.44	11.70	9.00
Total	18.46	23.15	22.59
<b>YTD</b>	<b>2010</b>	<b>2011</b>	<b>Change</b>
Pro Rata	77.77	141.20	81.6%
Institutional	157.64	231.87	47.1%
Total	235.41	373.07	58.5%

*S&P LCD Weekly*

# Portfolio Strategy – Non Dollar

January 2012

**Volatility driven by EU indecision. People's Bank of China cuts reserve requirements. Canada benefits from EU turmoil.**

## EUROPE

- We remain wary of core European bonds and currency.
- The GIIPS sovereign crisis continues to impair investor confidence, as prior hope of a quick funding resolution was dampened by a failure to produce a definitive plan. German opposition to joint European bonds and increased ECB action have stymied progress, while the failure of the IMF and EU to secure funding from developing nations has limited options.
- A recent lowering of funding rates/margin requirements for existing currency swap arrangements have managed to prevent further implosions in the interim, but any lasting impact from this move is questionable, given the stigma attached to borrowing from this facility.
- The final resolution to the GIIPS sovereign crisis could comprise a German-advocated strong fiscal union for Eurozone nations (which would avoid the difficulties of renegotiating existing EU treaty language) and IMF funding. However, commitments to the IMF for such funding remain elusive.
- Financial and economic problems in Hungary (not an EU member) weigh.

## AUSTRALIA, NEW ZEALAND AND CANADA

- We remain favorable toward the bonds of these dollar bloc countries, as well as the Canadian dollar, which benefits from its proximity to the U.S. While currently neutral on the Antipodean currencies, we look for opportunities in global-related tradeoffs.

- Long awaited easing by the People's Bank of China arrived with the first reserve requirement cut (50 bp) in several years. This mostly benefits New Zealand and Australia, as well as other Asian nations. Chinese data has remained consistent with a soft landing, which should be secured by further easing.
- Flows into Australia and New Zealand continue, with bond spreads tightening and currencies rallying. Meanwhile, Canada saw safe haven flows from Europe. Australian and New Zealand economies resumed a positive trajectory on rebuilding efforts, with Australia and Canada supported by strong commodity prices.

## UNITED KINGDOM

- We are cautious on the currency, given the proximity to the EU and its impact on growth, but favor the ten-year part of the gilt curve with continuing strong flows and dovish central bank policy. Inflation fears are moderating, leading the Monetary Policy Committee to consider additional quantitative easing. This is supporting gilts, especially versus European bonds, including German bunds, as U.K. gilts are considered a better credit risk, since the pound is outside the Eurozone.

## EMERGING MARKETS

- We continue to favor emerging markets, especially the higher-yielding countries with natural resources and solid government fiscal balances, such as Brazil and South Africa.
- Bond flows into local currency emerging markets continue with commodity-backed, fiscally secure countries faring best. Central banks are cognizant of negative moves in both currencies and bonds and continue to support either or both. Indonesia aggressively supports its bond markets, while others focus on currencies. Although fiscal conditions remain superior to those of developed markets, emerging markets remain sensitive to developments in Europe.

## Benchmark Performance – As of December 31, 2011

<u>Benchmark Performance</u>	<u>MTD%</u>	<u>YTD%</u>
Barclays U.S. Aggregate	1.10%	7.84%
Barclays U.S. Treasury	0.97%	9.81%
Barclays U.S. TIPS	0.04%	13.56%
Barclays Investment Grade Corporate	2.14%	8.15%
Barclays U.S. ABS	0.13%	5.14%
Barclays U.S. MBS	0.70%	6.23%
Barclays U.S. CMBS	1.31%	6.02%
Citigroup High Yield BB/B (excluding split B/CCC)	2.55%	6.83%
Citigroup Non-U.S.\$ World Government Bond (50% hedged)	1.43%	4.67%
	<u>Nov 30</u>	<u>Dec 31</u>
10-Year U.S. Treasury Yield	2.08%	1.89%

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