
Economic Outlook

March 2010

Global: growth pattern continues; however, bifurcation is evident.

- Developing countries of China, Brazil and India are leading global growth, with China's GDP reported currently growing at 10.7%.
- Europe, marred by the fiscal problems of Greece, Portugal and Spain, is expected to grow at 1.0% in 2010.
- Among the developing countries, Australia remains the best performing economy, despite three rate hikes last year by the Reserve Bank of Australia. In the most recent meeting, further increases were put on hold. Canada is also performing well with recent GDP reports coming in above +5.0%
- China and India have also taken recent steps to tighten policy in the face of accelerating growth and inflation.
- Japan, a 'low growth' economy, continues to face demographic headwinds, staving off deflation.
- Greece's fiscal problems continue to plague the European Union as well as the EMU. Although a pan-European solution has been proposed, lead by Germany, this does come at the cost of severe fiscal restrictions to Greece's Government. The fear is that as soon as any solution is hammered out, Portugal, Spain and Ireland will be next in line for a bailout.

Domestic: business spending fuels modest economic recovery in 2010.

- Economic reports generally indicate a pickup in activity in U.S. growth, driven by business spending. We expect GDP in the 3.0% range for 2010.
- Business spending for inventories and capital expenditures should support growth as companies become more confident with improved profits, revenues and access to financial markets.
- Consumer spending should remain weak based on sluggish job and wage growth, declines in net worth, rising taxes, and high debt levels.
- We expect unemployment to remain stubbornly high, around the current 10.0% level.
- Housing sales, prices, and inventories appear to have stabilized, but we remain concerned regarding the growing backlog of foreclosure inventory.
- Inflation is likely to remain benign over the medium-term. Excess capacity, falling wages, and declining rents should keep pricing pressures under control.
- The Federal Reserve will begin gradually removing monetary accommodation towards the end of 2010. Expect 50 bps Fed Fund target rate by the end of 2010.

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

Portfolio Strategy- Duration & Yield Curve

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Maintain neutral duration strategy, short- term. Longer-term, strategic short duration position may be considered as the time for Fed tightening approaches.

- Burgeoning U.S. deficits and a heavy supply calendar continue to pressure U.S. Treasury prices, with interest rates also under pressure for the remainder of 2010.
- 10-year yields remain range-bound between 3.2% and 3.9%, protecting politically-desirable, low mortgage rates. Bonds have rallied from recent lows on continuing uncertainty over Greece and the Euro. Long-term treasury yields remain inside their recent range
- Technicals remain neutral. The recent Fed minutes confirmed the winding down of quantitative easing by the end of 1Q2010, limiting the authorities' ability to control long-term interest rates.
- The steepness of the yield curve remains close to historical highs, with a flattening yield curve expected going forward. Our research implies that when yield curve flattening occurs, a barbell strategy is the most favorable.
- Despite the US treasury, rally there is concern that a recent decline in Chinese holdings is the beginning of a long-term trend. It may be, however, that the decline is linked to the gradual reduction of the trade surplus between the US and China, reflecting sluggish US domestic growth. Fewer surplus dollars are available to the Chinese to make these purchases.

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Portfolio Strategy- Investment Grade Credit

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Maintain Overweight. We expect the combination of attractive valuations, strong market technicals and improving fundamentals to continue to lead to strong performance for investment grade credit.

- Valuations are still very attractive as corporate spreads are still well wide of long-term averages. Also, corporate spreads are still near the wides of the last two recessionary periods (1991 and 2001).
- Fundamentally, the trends are positive. In general, companies have meaningfully improved their short-term liquidity, termed-out their debt maturities, and are in the process of reducing leverage. Top-line revenue trends have been encouraging lately and bottom-line profitability has been resilient. Financial institution profitability is recovering thanks to equity issuance, active capital markets, a steep yield curve, and stabilizing credit costs.
- Market technicals are strong. New issuance in 2010 should be relatively light, and demand is strong from both traditional and non-traditional market participants (such as equity funds).
- We favor companies with improving operating trends and those showing a commitment to debt reduction. In general, we also favor cross-over credits and 'BBB'-rated bonds, as we believe quality spreads will continue to compress.

Overweight: Banks, brokers, insurance, electric utility holding companies, telecommunications, cable-media, REITs, and pipelines

Underweight: Single 'A' industrials, consumer discretionary, and Yankee non-corporates

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Portfolio Strategy- High Yield

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Trends support further gains in high yield.

- The high yield market continued to consolidate in February with the Citigroup BB/B ex-split B/CCC Index up a mere 0.12%, following January's modest 0.71% gain. Ongoing concerns regarding rising sovereign risks, most notably Greece, and regulatory rumblings out of Washington D.C. have kept risk appetites suppressed.
- That being said, we have witnessed an improved tone in recent weeks as investors do their homework and get more comfortable with these situations.
- Fourth quarter earnings continue to surprise to the upside:
 - Top-line revenue growth is improving
 - Balance sheet strengthening persisted, aided by improved cash flow generation and the ability to issue equity
- Demand for high yield mutual funds fell in February, with two significant outflows mid-month, but inflows resumed in the final week of the month and year-to-date inflows now total over \$1.2 billion. We believe that the positive risk/return attributes will continue to attract new investors over 2010.
- Global high yield default rates declined to 12.5% in January (Moody's 12 month trailing rate) from their peak at almost 13.5% in November. The pace of defaults in the past three months marks the lowest dollar volume since October 2008.
- The primary market remained robust, with over \$16 billion issued in February and year-to-date new issuance now totaling over \$36 billion. This follows the record \$185 billion in global new issuance completed in 2009.
- As always, we are focused on credits that possess solid balance sheets and favorable operating trends. We remain cautious on consumer discretionary sectors, but have recently added some exposure to top tier issuers in such industries.
- While merger and acquisition activity is expected to rise, we believe that most deals will continue to be conservatively financed and be driven by larger/higher rated companies looking for top-line growth in the current environment.
- To take advantage of this, we are identifying undervalued high yield companies that are likely to be purchased by higher rated corporations.
 - Overweight:** Banks/brokerage, energy, gaming/lodging, insurance, paper/packaging, pipelines, railroads/transportation, REITs, technology
 - Underweight:** Aerospace/defense, autos, building materials/housing, electric utilities, food/beverage/tobacco, industrial–other, metals/mining, non-captive finance, retail/restaurants, supermarkets

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Portfolio Strategy- Governments & TIPS

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Governments: remain underweight.

- Currently underweight both the U.S. Treasury and agency debenture sectors with better relative value in credit sectors.
- Agency yield spreads have little room for improvement after recovering from 2008 sell-off.
- Federal Reserve's purchase plan nearing conclusion, 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 out of favor as deflation will be a larger concern than inflation in the next six months.
- Unprecedented government stimulus and a weaker U.S. dollar should produce future price pressures and a positive environment for TIPS.

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Portfolio Strategy- Structured Products

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Mortgages: no change, remain underweight.

- Currently underweight agency mortgages with better relative value opportunities in other spread sectors.
- MBS vulnerable to the conclusion of the Federal Reserve's mortgage purchase plan in the first quarter of 2010.
- Mortgage market fully valued with spreads recovering from 2008 underperformance.
- Refinancing risk remains muted, but delinquent loan buyouts could pose problem for higher coupon MBS.
- Overweight 30-year mortgages with focus on 5%, 5.5%, and 6% coupons.
- Strong investor demand and attractive relative value should continue to support non-agency MBS.

ABS: underweight and selective.

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

CMBS: remain overweight; take profits on strength.

- Cautiously optimistic on CMBS sector as positive technicals outweigh deteriorating fundamentals.
- The government PPIP/TALF plans have improved demand technicals and tightened yield spreads.
- Strong relative value versus investment grade credit has broadened investor interest in sector.
- Commercial fundamentals continue to deteriorate and remain vulnerable to labor market and consumer spending weakness.

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Portfolio Strategy- Non Dollar

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Dollar bloc rules, gilts re-emerge.

- Record U.S. Treasury issuance has put downward pressure on U.S. bond yields and the dollar; however, high bank and foreign demand continues to keep U.S. Treasury yields in check.
- Outlook for the dollar remains negative, but currency selection is expected to be more important in 2010, with the U.S. economy recovering and the market jittery in anticipation of a Fed rate increase.
- Our currency positions remain concentrated in dollar-bloc countries with emphasis on Australia and New Zealand. These offer the most attractive bond opportunities given the strength of the Australian economy and improved liquidity in the New Zealand bond market. However, the pace of Aussie dollar appreciation has slowed due to the recent pause in rate increases by the RBA, concerns over international sovereign risk and potential China slowing.
- European conditions have improved, but at a slow pace. Uncertainty prevails with Greek budget difficulties putting pressure on both the Euro and peripheral bonds. The European Central Bank remains reluctant to raise rates. We sold our French bond, due to concerns over possible bailout of Greece weighing on core Europe credit.
- We reentered the gilt market, at wide levels versus European bonds. While the UK has fiscal difficulties, the economy is in a relatively better position than core Europe. Additionally, short positions in gilts are at extreme levels, which should spur significant covering with positive bond news. Finally, recent MPC (monetary policy committee) statements have indicated a possibility of a return to QE if conditions warrant, which would support gilts. Our bond position is fully hedged, as we remain negative on the currency, due to political uncertainties and a possible coalition government with new elections rather than a complete change to conservative control.
- Canadian bond spreads are at richer levels versus U.S., with the Bank of Canada on hold regarding rate increases. The currency has significant upside, with strong commodities backed up by improved domestic demand. Our Canadian positions remain unhedged.

Benchmark Performance

March 2010

<u>Benchmark Performance</u>	<u>MTD%</u>	<u>YTD%</u>
Barclays U.S. Aggregate	0.37	1.91
Barclays U.S. Treasury	0.40	1.98
Barclays U.S. TIPS	-1.16	0.43
Barclays Investment Grade Corporate	0.36	1.99
Barclays U.S. ABS	0.48	2.16
Barclays U.S. MBS	0.18	1.51
Barclays U.S. CMBS	1.89	6.50
Citigroup High Yield BB/B (excluding split B/CCC)	0.12	0.83
Citigroup Non-U.S.\$ World Government Bond (50% hedged)	0.39	0.38
	<u>Jan. 31</u>	<u>Feb. 28</u>
10-Year U.S. Treasury Yield	3.61%	3.86%

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