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Looking Forward... or Backward?

As we flip the calendar, we are amazed by this January's similarities to prior ones. As in the past two years, the start of 2012 has been dominated by strong economic news and optimistic corporate earnings. As a result, markets are starting this year in a bullish mood, despite recessionary fears percolating in Europe and the possibility of slowing growth in China.

The big question for fixed income investors to ponder is, "What makes 2012 different than 2011 and 2010?" Should we expect the optimism to be reversed as in prior years resulting in further central bank intervention? Or will 2012 be different and reward investors for adding risk to their portfolios?

We have identified two main headwinds that may significantly impact growth in 2012 and force the Fed to once more intervene in the markets with QE3. First, the stamina of the US economy will be tested by the waning effects of the American Recovery and Reinvestment Act and of the spending caps that were mandated under the Budget Control Act. This obstacle will likely become a pawn in the election process as the President and GOP candidate(s) twist fact into fiction to better position their platforms for the November election. As a result, the lack of political clarity out of Washington may continue to deny corporations the confidence needed for resumed capital expenditures and hiring, thereby hobbling the economic recovery.

Second, Europe remains a mess. Over the past year, economic and financial stresses have spread beyond the PIIGS to the entire continent. The crisis is now a deep-rooted systemic problem not just for the European Union nations, but for financial systems and economies worldwide. Given the strong fiscal links between the US and Europe, we expect the US markets to be impacted by European developments throughout 2012. These links were highlighted during 2011 as negative correlation between the 10-year Treasury rate and European 5-year CDs increased from (0.61) to (0.93).

The US Federal Reserve bank has echoed these fears over the past six months. While the FOMC broadly anticipates moderate growth and some easing of inflation pressures, committee members remain concerned about downside risks posed by stress in the global financial markets and the still-elevated unemployment rate. Nonetheless, the FOMC is quick to point out that recent statistical releases indicate improving conditions in the manufacturing, energy and agriculture sectors, in addition to potentially improving conditions in the housing sector. We suspect the Fed is using its published forecasts to purposefully foreshadow its plans to ease or tighten in an attempt to exert more control over 2 to 10 year interest rates. We find this move to be ingenious because it will likely provide short-term stimulus by keeping rates artificially low now while still ultimately allowing the Fed to push longer rates higher at the appropriate time.

We expect bond yields to remain range-bound until the EU takes definitive steps to address their problems. The ground work for this process was laid at the Super Summit in November where European leaders (and the US Fed) finally admitted that the debt crises is a global issue and the EU

Central Bank pledged to act as the lender of last resort to banks, rather than countries. This change in strategy is important because it paves the way for the shakiest countries – Greece? Italy? – to restructure their debt or even default without sinking the European Union.

We believe that low inflation will continue to be a key theme that will also reinforce the recent trend toward lower rates. The 10-year US Treasury Note currently has a negative real rate of return while Treasury Inflation Protection Securities (TIPS) – which we monitor closely – currently have a break even (TIPS yield minus Nominal bond yield) rate of roughly 2% rate which reflects the market's low inflation expectations.

For 2012, the probability of an extreme move – 100 b.p. or more – in Treasuries is remote since current inflationary pressures are too low to spike rates up anytime soon and, conversely, rates are already so low that there's not much room for them to fall sharply.

Average 10 Year Yield	
Year	Rate
2006	4.79%
2007	4.63%
2008	3.64%
2009	3.24%
2010	3.20%
2011	2.76%
2012 Forecast	2.20% to 2.40%

Source: Bloomberg

Although we expect the 10-year Treasury yield to average about 2.20% - 2.40% in 2012, thereby continuing their 6-year downward trend (see table), we also believe that rates either have bottomed or will bottom in 2012. In the near term, the 10-year could drop as low as 1.50%, but we think that rates will be on the rise by the second half of the year and that the 10 year Treasury will end the year close to the current 3+% rate of inflation. While not eye popping, this will pave the way to higher rates in 2013 as real rates normalize and become positive

for the first time since 2008. We look for continued volatility in the bond market.

Regional municipalities continue to face dual headwinds caused by the need for additional spending cuts and the uncertainty of November's general election. That being said, we believe that yields on high quality municipal bonds (specifically large issuers' general obligation and essential revenue bonds) continue to remain attractively priced relative to Treasuries. For example, the largest municipal bond ETF closed the year with a yield of 3.28% while a Treasury bond ETF with comparable duration closed the year with a yield of 2.52%.

The municipal market finished the year strongly as "Black Swan" events, such as those predicted by Meredith Whitney, never came to fruition. Despite two headline-grabbing municipality defaults in Jefferson, AL and Harrisburg, PA, spreads narrowed throughout the year and restructuring remained at low levels.

On a positive note, cost cutting austerity measures are starting to kick in at the local level and as reported in the 9/30 Census Bureau release, state tax collections grew an average of 9% year-over-year nationwide. The only states that failed to grow tax revenues over the past 12 months were Alabama (-5%) and New Hampshire (-1%). Another promising sign is that states which typically act as leading indicators in cyclical recoveries (e.g., California) are experiencing strengthening growth rates. Similarly, energy producing states such as North Dakota, Wyoming and Montana – the US leaders in shale oil production – continue to grow strongly. On the manufacturing side, improved US auto maker sales have created promising growth in Michigan and Indiana as domestic auto manufacturers climb to a 78% market share in the US – their highest since 2006. These industrial indicators of economic recovery are encouraging because their positive impact should start showing up at the municipal level in the not-too-distant future.

We must point out that regional municipalities (cities, townships, counties, etc) will remain at-risk as long

as the housing market continues to struggle. Recent reports show that home sales appear to be rebounding and housing prices are showing some signs of stabilizing from the 2nd to the 3rd quarter. However, more recent city data from S&P Case/Shiller shows deterioration in several key areas such as Atlanta (-12% Oct. vs. -10% Sept. year-over-year), Los Angeles (-5% vs. -4%), and Las Vegas (-9% vs. -7%).

Although we do use municipal bonds for institutional accounts, we remain cautious about placing individual municipal bonds in smaller accounts that have less diversification and that would be more damaged by a default – a more likely event if the current environment weakens. In addition, as was the case in the first quarter of 2011, smaller sized positions will be more difficult to sell at fair value if the municipal market falters. Given those concerns, ETF's may be a more appropriate way to fill municipal bond allocations in individual portfolios.

We have been very defensive in our bond recommendations for the past 18 months. Our defensive positions have included being short duration, short economic sensitivity and short credit (specifically finance). That being said, at some point, the next big trend will emerge in the bond market and we have to keep looking ahead so that we're ready for it. As such, we continue to monitor two important concerns: the general state of the U.S. economy and the Europe debt crisis.

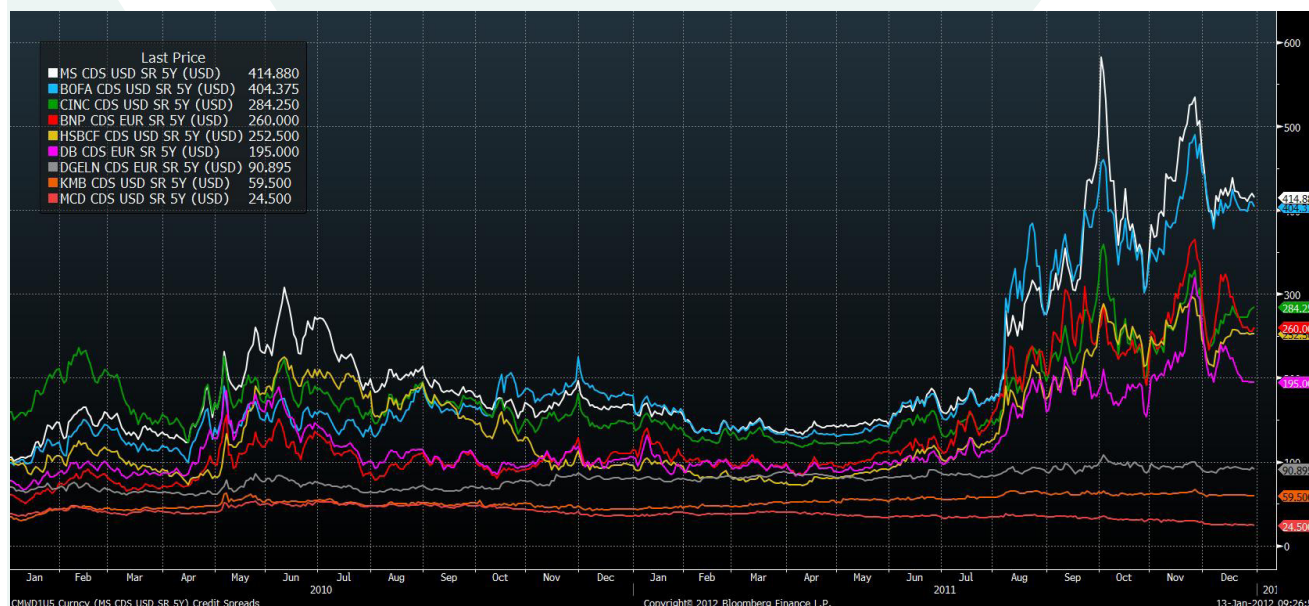
At this point we are more confident that we are seeing improvements in both areas. First, the bulk of US corporate and economic news has been neutral-to-positive over recent months. Second, while the European crisis is not over – and it will not be for a very long time – we feel that we have reached the tipping point that will eventually lead to a fiscal resolution. Much like any multi-step process, the first step is always to identify the problem and to set a goal. Globally, the key players now acknowledge that the crisis is a worldwide problem and there is a new sense of urgency amongst world powers (including the US) to resolve it. As a result, while Europe will likely be mired in recession in 2012, we expect the Euro to survive as the single currency and – if regional inflation can be controlled by the ECB without inflicting undesirable levels of inflation on any of the stronger countries such as Germany – European-wide growth should resume in 2013.

It will remain difficult to discern the true value of global corporate bonds so long as there exist financial bonds offering “fools gold” in the form of unrealistically high yields that will potentially implode. During the second half of 2011, investment-grade and high-yield bonds both had rising yields (e.g., both Bank of America (BOFA) and Morgan Stanley (MS) have seen spreads widen by as much as 500 basis points in 2011) and underperformance relative to U.S. Treasuries. We would not be surprised to see an increased number of “equitizations” – just a fancy word for “defaults” – in 2012. Although we feel there is still such thing as “too big to fail,” we expect the financial sector to underperform in the near-term and we are reiterating our underweight position in US and European financials (see graph for spread performance in 2010 & 2011).

At the same time, however, the underlying fundamentals of most U.S. corporations continue to improve. It has become clear that companies' earnings are strong, balance sheets are robust, and many companies are continuing to find room to cut costs. As a result, we feel that as the European situation shows signs of improvement, there should be a narrowing of spreads in 2012.

Bond investors should remain focused on quality and invest in the most fiscally sound sovereigns, such as Canada and Australia, and in the highest quality investment grade corporate bonds of multi-nationals, such as Diageo (DGELN), Kimberly Clark (KMB) and McDonalds (MCD). Such companies benefit from multi-national reach in relation to national regulatory risks, as well as strong cash flows and healthy balance

sheets. This fact was highlighted over the past few years as their spreads have remained tight while the spreads of riskier financial companies have widened with tremendous volatility (see graph).



Source: Bloomberg

The bond market has generally been the beneficiary of the global chaos for the past five years, but we feel it is now time to reassess how one views the market. Clearly, rates cannot go down forever, nor can spreads stay so tight and many forecasters have been calling for the end of the bull market in bonds. In a changing environment, the challenge for fixed income investors is to clearly understand that bonds can still be a good place to be – IF you properly manage your risk exposure.

Although “aggregate” benchmarks represent the bulk of the bond market and are used by most investors to gauge performance, we advise caution in blindly following them in this market because such benchmarks typically contain hidden concentrated risks in sovereign debt, industries (such as finance) and duration.

We advocate the use of more equally weighted, high quality and – ideally – duration based benchmarks,. Furthermore, we generally recommend “strategic” bond portfolios that balance risk and return. This will ultimately provide investors the ability to move away from bonds that expose them to increasingly indebted institutions, municipalities and sovereign governments in favor of duration based investments in strong or improving balance sheets that will provide principal protection and steady growth in any economic environment. We feel that this will ultimately allow investors the flexibility to change strategies quickly when the main headwinds subside.

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