The age of discovery

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This week the US goes to the polls for the mid-term election, the Fed is widely expected to announce the next stage of quantitative easing, and we get a broad update on the state of play in the economy. This is a lot of news for financial markets to digest. In fact we suspect this information will provide the basis for many analysts to finalize their outlook for 2011. All of these events: (i) politics, (ii) Fed policy, and (iii) the economy, could influence our medium term strategy going forward.

US Politics

The risk going forward is for political gridlock

As we write, our working assumption is Republicans gain control of the House but the Democrats manage to maintain a slender margin in the Senate. For financial markets the focus will be on the expected policy framework going forward. To date the Republicans are being rewarded for saying no to pretty much anything proposed by the Democrats. So, with the focus on the 2012 Presidential election, the prospect is for the Republicans to maintain this policy approach for the next two years. The result could be a form of political gridlock, where fast or decisive policy response will prove difficult.

The expiration of the Bush tax cuts could be a meaningful negative impact to growth

This situation will have consequences. In the short term, agreement needs to be reached over what to do about the expiry of the Bush tax cuts at the end of the year, and the expiry of the emergency unemployment benefits on November 30th. In the longer term, political gridlock implies there will be little commitment to addressing the longer term fiscal issues facing the US. The US typically relies on strong growth to sort out the budget deficit. If the Bush tax cuts are not extended (or made permanent) and the emergency unemployment benefits are not extended, there is a significant risk inaction could cause a negative growth shock to the economy in the coming quarter. Thus, watching how the post-election politics evolves around these issues will be important for financial markets.

Fed Policy

The Fed is embarking on further quantitative easing, but there is limited support this will return the economy to a sustainable growth path

The Federal Reserve, through various speeches and statements, pre-announced a commitment to further quantitative easing. This week we will find out exactly what form that will be delivered. In the US, quantitative easing is being defined as the purchase of intermediate Treasuries. To date this action has had an impact in terms of reducing the overall borrowing costs for the economy, and cheapening the dollar. The question being asked throughout the financial markets is whether quantitative easing will return the economy to stronger and sustainable growth?

Quantitative easing has lowered interest rates, with meaningful benefits to Corporations

Quantitative easing has pushed interest rates lower. This has had a positive impact on Corporations, by lowering their cost of capital. Corporations, though, were already in good shape and in fact have a lot of cash on the balance sheet, so the benefit for the economy as a whole is at best modest. Mortgage rates too have been pushed lower, with 30-year borrowing rates now standing around 4.25% compared to levels near 5.0% during the first half of 2010. Chart 1 illustrates the relationship between lower mortgage rates and mortgage refinancing. The chart shows there has indeed been a increase in refinancing activity as a result of the fall in rates, but not to the same extent in 2002-2003 when the Funds rate plunged to just 1%. In addition, the housing market statistics show a bottom but few signs that there are better times ahead.

We are in a balance sheet recession and quantitative easing cannot fix that

The problem with quantitative easing is that it will not alter the reluctance of banks to lend. Nor, we believe, will it dramatically boost weak household demand for credit given that consumers for the most part remain in balance sheet repair mode.

QE II is lowering the real cost of capital and that has been a success

However, in the words of our economist Lewis South, if we set a modest goal for quantitative easing, that being to help lower real interest rates in the economy and the exchange rate so as to help prevent the US economy re-entering recession and provide a supportive environment for households to deleverage, then yes, quantitative easing can be successful.

The long term impacts of today's monetary and fiscal policy is unknown

Perhaps the main problem we have with quantitative easing is the uncertainty surrounding the end game. Quantitative easing is an unconventional policy tool for the Federal Reserve and this means we have entered uncharted territory. The uncharted territory is that the impact of the policy on financial market variables and the real economy is not known with as much precision as say a traditional policy tool such as interest rates.

Our problem with QE is there are risks in both directions

Our economist, Lewis South, explains that medium term policy risks are in both directions. Firstly, the risk the Fed is not doing enough – that is, the Fed is too cautious or the economic agents set unrealistic expectations for policy, risking an erosion in confidence for the Fed achieving its goal which could cause inflation expectations to be marked down, real rates to rise and threaten pushing the US into a Japan style liquidity trap. Secondly, there is risk the Fed does too much – that is, the action drives too large an increase in inflation expectations and economic agents fear the Fed will not be able to withdraw policy stimulus in a timely fashion or create speculation the Fed is simply monetizing the debt, fuelling inflation expectations and significantly pushing up interest rate expectations.

For the record, we believe the Fed will prefer the latter risk as a more palatable option.

The Economy

The economy continues to show weakness in the key consumer areas. Until employment picks up, growth will remain sub-trend.

To date, this economic recovery is lagging the rebound that typically takes place following a recession, see chart 2. However, the earlier fears of a double-dip have receded, partly due to the resilience of the economic data and the belief quantitative easing will put a floor on the downside risk for the economy. This week, the stronger than expected Manufacturing ISM, at 56.9, was very encouraging, particularly as it was supported by a rise in the production component of the Index. That said, as we wait for the employment report on Friday there is little evidence that job creation has re-ignited. This will keep pressure on income and confidence and therefore spending.

Chart 1: The Fed has been successful in lowering the most important consumer borrowing rate

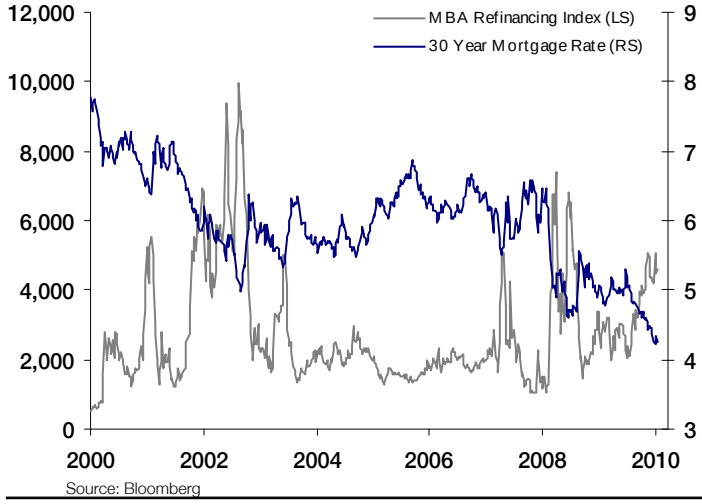
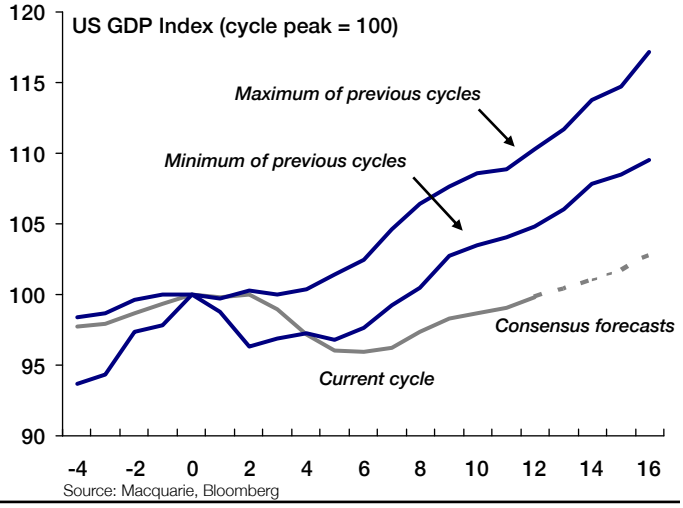


Chart 2: US GDP is well below previous cycle averages, and consensus expectations are muted



Corporations have dramatically improved their credit profiles

The good news is from Corporations, revealed in last quarter's earnings picture. Corporations are in good shape: the default rate has fallen considerably and expected to remain low for the next 12-18 months, companies are sitting on record cash levels, leverage has steadily decreased, debt maturity has been increased, and past cost cutting has provided companies with good operating leverage. The biggest concern we see is the potential risk on the horizon of an increase in shareholder friendly activity such as share buybacks, increased dividends, LBO's etc.

Investment strategy

A good year for fixed income

This has been a good year for fixed income. Treasuries have generated a 8.5% return year-to-date. This compares to 7.9% from equities year-to-date. Within fixed income, CMBS continues to deliver the highest returns, now in excess of 20% year-to-date. Corporates too are delivering double-digit returns, clocking 10.9% year-to-date (Source for figures: Barclays). This data reveals the rally in the levels of rates across the curve has been the key generator of fixed income returns. The performance by Corporate bonds has not been a surprise, as their fundamentals are so robust. CMBS, with its weaker fundamentals, has been the big surprise to many, and has attracted strong flows in recent months as investors have begun to chase yields.

Slow growth, low inflation and strong bottom up fundamentals should keep fixed income as a favored asset class

Looking ahead, the combination of robust bottom up fundamentals and a macro-economic outlook for modest growth suggests fixed income will remain a favored asset class. We continue to overweight Investment Grade Corporates, believing in stable yield advantages and potential for further modest spread tightening. We continue to be overweight CMBS based on a strict process of credit/structure selection.

We are neutral on the outlook for duration, believing that much of the benefit of quantitative easing is already in the price. We prefer to concentrate our Treasury holdings in the belly of the curve.

Portfolio Positioning and Strategy

Macquarie Allegiance manages separate accounts, invested in fixed income securities including Government-only, AAA-only and Investment Grade portfolios. Below is a summary of our Investment Committee views at month end.

Neutral duration as QEII recommences and the Federal Reserve is on hold for the foreseeable future

Duration: *Neutral*. A neutral position is warranted through the view interest rates look well anchored, quantitative easing has re-commenced and inflation remains far below Fed comfort levels. Technical analysis, an important part of our investment process, confirms the view interest rates remain well anchored.

In our view, the 5-7 year area of yield curve looks poised to perform well

Yield Curve: *Overweight 5-7 year maturities.* We positioned portfolios to benefit from 5-7 year maturities outperforming shorter and longer maturities. We expected the belly of the curve to have optimal "roll down" as well as preferred status for Fed purchases. The portfolios benefited from 5-years outperforming 10-years by about 20 bps, and 30-years by about 40 bps (Source: Barclays). In light of the our expectations of QE2, we continue to view 5-7 years as the optimal position on the yield curve.

Treasury yields look to remain low as QEII recommences

Treasury and Agency: *Overweight Treasuries, underweight Agencies.* Our Treasury overweight is driven by our slight overweight in Agency MBS and near zero weighting in Agencies. With QEII, we see Treasury rates well anchored at today's low levels, in particular in the intermediate part of the yield curve (5-7 years), where we expect the majority of Fed purchases to be concentrated.

Many of our concerns over Agency MBS have passed, and we are looking for opportunities to increase our exposure

Agency MBS: *Overweight.* We have been evaluating closely the Agency MBS sector as concerns over October Surprises and pre-payment risk has left us cautious. Entering November, our view on Agency MBS is more constructive and we believe many of the risks associated with the sector, such as election cycle politics, have passed. We continue to focus our positioning in seasoned, up in coupon MBS that in our analysis have limited pre-payment risk.

In our view, Corporate Bonds are attractive due to bottom up fundamentals

Corporate Bonds: *Overweight.* In our view, Corporate bonds remain as one of the more attractive asset classes within fixed income due to the strong bottom up fundamentals in the sector. The continued record low yields on recent new issue securities is indicative of investor appetite for credit.

Neutral on CMBS as poor sector fundamentals keep us cautious

Structured Credit: *Underweight ABS, Overweight CMBS.* CMBS, which have been a key driver of our performance in many strategies, have moved to fair value in our models and we are at a slight overweight. While we see value in many CMBS structures where we use our credit intensive security selection process, heightened volatility, poor overall sector fundamentals and risk aversion leaves us cautious on CMBS.

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