

NCA BOND REPORT

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A MARKET TRAPPED IN DYSFUNCTION

We stand at the half-way point of 2009 and the investing world seems trapped between ‘cautious pessimism’ and ‘tempered optimism.’ Is it possible that the glass is half-empty *and* half-full? A survey of asset classes for the last quarter demonstrates that risk-related sectors outperformed safe havens by a wide margin:

Asset class	Q2'09 return
S&P Index	15.9%
CRB Index	14.8%
Corporate Baa-rated bonds	12.8%
1-5 Yr. Tips	1.4%
10+ Yr TIPS	0.7%
1-10 Yr TIPS	0.6%
Corporate Aaa-rated bonds	0.2%
5+ Yr TIPS	0.2%
1-5 Yr Treasury	(0.9%)
10-20 Yr Treasury	(6.0%)
20+ Yr Treasury	(9.4%)

Source: Barclays & Bloomberg, Corporate returns are total

We noticed during the Fourth of July weekend a slew of sell-side research reports riddled with ways to take profit and play defense in the second-half of the year. Though, risk returned in a big way following the recent equity market pull-back beginning in late June. Is risk back on permanently, or will we see a change of course yet again in the next few weeks? Perhaps it is for every trend that excites bulls (for example, rising ISM data, falling continuing jobless claims, a bid in the commodity market, deficits *don't* matter) there are an equal number of trends that are presenting headwinds (for example, 10% potential unemployment, rising personal saving rate, low industrial capacity, and oh, by the way, deficits *do* matter).

Yes, we certainly have come a long way from the Armageddon scenarios that hung over the first quarter of 2009. But *as we have been saying for the last few months: that is simply not good enough!* Of note, 51% of the respondents of the Bank of America Securities – Merrill Lynch 2009 Semiannual Credit Survey said that a protracted recession was the biggest worry. We collectively find ourselves in search for something that will sustain growth beyond 2009.

We think that the US economy will remain slightly schizophrenic as long as individual participants cannot get a good feel on what growth (and consequently prices) will be like in front of this contradictory data.

Shades of uncertainty are no doubt clouding corporate capex planning and hiring decisions. Think about it: if you had \$1 billion in cash would you build a factory this year or keep it on your balance sheet? How could you determine an investment hurdle rate if it's quite easy to visualize both a weak 2010 GDP forecast of +.75% from the IMF or another forecast within the Fed's range of +1.5% to +4.0% growth.

We think we will eventually see a stabilization of economic data in 2010, but for now we are taking a more tactical view on investing. We remain bullish on the corporate credit market, which we think will continue to operate relatively well in this grey area. *Forbes Magazine* recently ran a headline that said “Dump Stocks, Buy Bonds.” Their advice, simplistically geared to the retail investor, was simply lock in the yield and capital preservation. As credit analysts, we take it a few steps further and plug in our own gloom and doom scenarios in models, and arrive at credit metrics that are still supportive of investment. Though, the *Forbes* thesis is sound, and we think this asset class will win the Keynesian beauty pageant this year.

HIGHLIGHTS

- Risk taking loses steam mid June
- Commodity prices fade mid June after year to date surge
- Bond markets offer positive returns
- Breakeven inflation rates begin to reflect the change in sentiment; for June, linkers still outperform in most markets
- Currencies. Yen reappears as a safety value

RETURNS

	June	2009
1-5 yr TIPS	-0.14%	5.86%
TIPS Market	0.50%	5.33%
Global Linkers	0.89%	6.80%
Barclays Treas.	-0.21%	-4.30%
Barclays Agg.	0.57%	1.90%

INSIDE THIS ISSUE:

JUNE REVIEW	1
GLOBAL LINKERS	2
THE TIPS CURVE	3
RETURN DATA	4

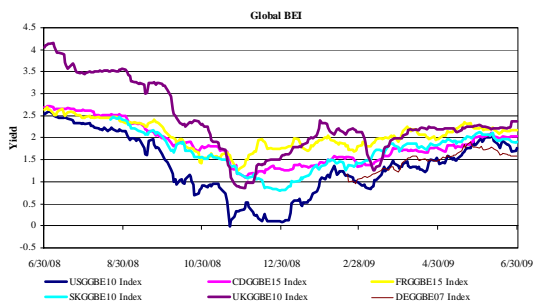
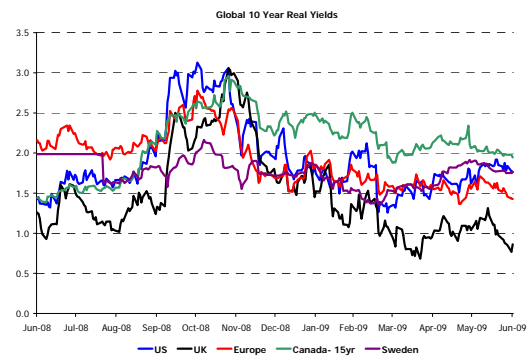
As for Treasury yields, we remain bullish for the near-term. We think the sell-off in the second quarter was overdone, fueled by runaway inflation fears, the green shoots theory, and the “too much supply” thesis that is consequently thrown around the market these days. Long-term it’s hard not to be bearish on rates. For starters, at some point the Fed may begin to unwind its balance sheet and remove liquidity from the economy. This would certainly put upward pressure on rates. Although, when (and if) this happens is anyone’s guess—the Bank of Japan maintained low rates and pursued quantitative easing for nearly a decade and is still battling a weak economy and deflation. The Fed’s massive quantitative easing actions thus far have failed to create credit, succeeding only in creating bank reserves. Further, we’ve seen a number of banks shuttered including large middle market lenders like Indy Mac and WaMu. To add insult to injury, CIT Group is now on the ropes. All of this activity acts to further compress an already anemic money multiplier. Accordingly, we don’t see the Fed changing course soon nor do we think The Fed needs to change course anytime soon. From a risk to the economy standpoint, we are less worried about Fed policy than we are about our current fiscal policy.

The biggest near term risk, in our view, is further misguided fiscal policy. With Obama’s approval ratings falling and with the administration’s posturing about “misreading the economy” they inherited, we think the skids are being greased for another colossal package. Lets hope we are wrong. At best the evidence in support of a multiplier effect is mixed. Say what you will about consumers (i.e., taxpayers) maybe they are irrational, maybe they do not understand budget constraints; however, we do think they understand that every dollar of government spending is either one fewer dollar they have today or one fewer dollar they will have in the future—the Ricardian equivalence. Of course, not every taxpayer will object to paying for Government projects if funded by tax increases, especially if tax cuts target the “rich”. However, Christina Romer, the Chairwoman of the President’s Council of Economic Advisors should know better. In her work *The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks*, Christina D. and David H. Romer, (March 2007), she concludes “The resulting estimates indicate that tax increases are highly contractionary”. In other words, Obama is not only ignoring his Chairwoman’s research, but also believes that he can better allocate resource than the invisible hand. Seems like a bold move to us.

GLOBAL INFLATION LINKED BONDS

The first half of 2009 was characterized by considerable outperformance of linkers, primarily due to the poor performance of nominal bonds. In short, real yields rose less than nominal yields. The impact of large stimulus packages, and therefore tremendous financing needs of governments overwhelmed weak fundamentals. The linker outperformance also represented something of a return towards normal, as did the compression of credit spreads and liquidity spreads in markets such as ABS and CMBS. More recently, however, a change in sentiment regarding growth prospects and inflation was evident in most global linker markets starting mid-June and has persisted into July.

For starters, oil prices rolled-over. After rising continuously from a low of \$35 to a high of \$79, oil has recently dipped below \$60. Further, nominal interest rates have also reversed course. After approaching 4%, 10 year yields fell back to 3.3%. Perhaps a slower rate of economic decent doesn’t qualify as a green shoot. Regardless, the change in sentiment and the accompanying risk aversion has taken breakeven inflation rates down sharply (see chart below).



Source: Bloomberg, New Century Advisors

In the European markets, Nominals outperformed linkers, despite strong price returns in the long dated linker markets. In the US, where long dated linkers also had strong price returns, TIPS outperformed Nominals. This was the case in Canada and the UK as well. As the chart to the left shows, the upwards trend in breakevens seems to have stalled, and if we extended the chart into July, the breakeven compression continues as the investor community grows more skeptical of growth. The Japanese linker market, which through May had a negative return of -2.82% in local terms, had the best performance of any market in June, at 2.9%, given its real yields above 3%, some indications that the economy is improving, and the promise of continued government buy-backs.

While currency returns were mixed for the month of June, the Japanese yen, which often signals flight to safety, has appreciated 6% versus the dollar in the last 30 days, and even more versus the high yielding /commodity currencies which performed so well in the first half of the year.

After several months of normalization, the dramatic undervaluation that was prevalent in most risk assets, has been removed. With a few exceptions, this is also true of the global linker market. We are now entering an environment where fundamentals are likely to be a more important driver of future returns. For global linker investors, this means reconciling a very weak global economy and expanding output gap with the risks that the tremendous global monetary and fiscal stimulus will ignite inflation. While we favor the former (e.g., deflationary pressures) for the intermediate term, one

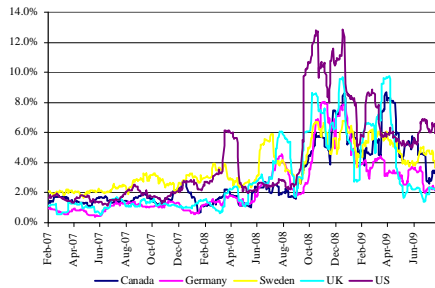
thing is for sure, we are keeping our fingers on the trigger. The chart at the left shows 30-day rolling BEI volatility. While it has come down, it is still very high compared to history, and it remains 2-3x 'normal' in all markets.

Sentiment changes have been sharp with BEIs particularly sensitive to moves in nominal rate and auction success. As a buffer to our nominal holdings, we continue to favor commodity, resource and infrastructure related corporate names. It's our view that even absent a recovery, the demand for commodities coming from China will be supportive of these plays.

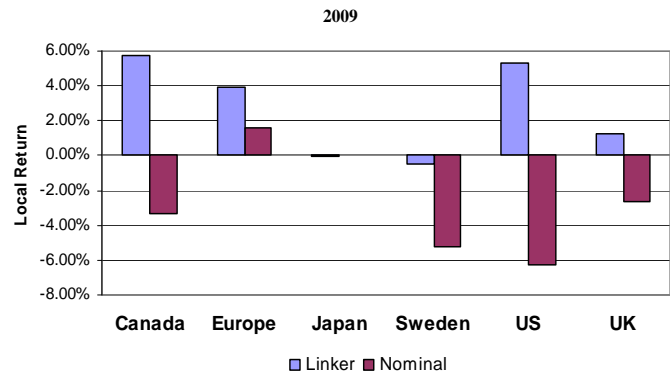
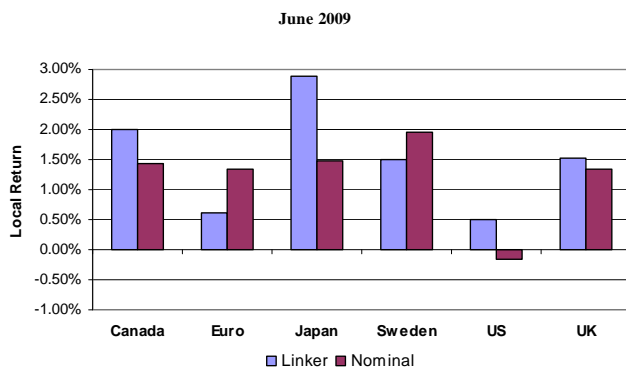
CURRENCY RETURNS YTD

- AUD 14.77%
- CAD 4.86%
- EURO 0.44%
- KRONA 1.72%
- STERLING 12.78%
- YEN -5.94%

SOURCE: BLOOMBERG



Source: Barclays & NCA



TIPS MARKET RELATIVE RETURNS

The performance in the TIPS market came at the long end of the yield curve in June. Real yields fell and breakevens widened, flattening the yield curve, whereas intermediate TIPS suffered from rising yields and narrowing breakevens. As a result, the TIPS market as a whole fared better than the 1-5 year sector. TIPS with less "deflation" protection, ie. those with less value to the deflation floor, were superior performers in June, as they have been all year. A good example of this could be seen in the TIPS of July 13, which have outperformed a the TIPS of April 13 by more than 500 basis points in the first half of 2009. Since mid-June, as could be expected with a change in investor sentiment, this relationship is beginning to change as well.

	TIPS		Nominals	
	1-5 Year	TIPS Market	Barclays Treasury	Barclays Treasury 10+
June	-0.14%	0.50%	-0.21%	0.67%
2009 YTD	5.86%	5.33%	-4.30%	-12.00%
TIPS Market Attribution				
	Total Return	Price Return	Coupon Return	Inflation Return
June	0.50%	0.07%	0.18%	0.25%
2009 YTD	5.33%	5.75%	1.09%	-1.50%

While total return due to inflation accrual during June was positive, inflation return has been a drag on performance this year, reflecting the decline in headline inflation, particularly early in the year. We still expect some drag due to this effect, should commodity prices continue to fall.



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HISTORICAL DATA ON GLOBAL INFLATION LINKED BONDS

The global inflation-linked bond market is over \$1.5 trillion in size. Both developed and emerging governments are embracing inflation risk as part of their overall expenditure policies. US TIPS remain the largest country component of this bond market (approximately \$500 billion), followed by the Eurozone governments. but issuance from historically inflation-prone countries has increased significantly over the last two years.

The historical asset class performance for these instruments is in the table below. Overall, this bond class exhibits excellent risk-adjusted performance and diversification benefits within a total portfolio context. Note the difference in volatility among the market indexes, with the overall TIPS market reflecting the volatility of longer dated real interest rates, compared to the less volatile TIPS 1-5 year index. Correlations are not stable, and in the more recent 2 year period all correlations to the S&P 500 increased from the 5 year period.

The superior return of the Barclays Aggregate Index (formerly Lehman) in the last year was the result of the extreme flight to Treasuries, which make up 22% of the Index.

We continue to update this chart periodically.

	History of Inflation-Linked Bonds						
	Annualized Return			Volatility	Information Ratio	Correlation to S&P 500	
	1 Year	3 Year	5 Year	5 Year		2 Year	5 Year
U.S. TIPS	-1.19%	5.75%	4.94%	7.11%	0.69	0.44	0.30
U.S. TIPS 1-5	-0.84%	5.27%	4.32%	4.18%	1.03	0.42	0.27
Global Linkers	-7.25%	5.07%	5.54%	9.53%	0.58	0.62	0.49
Global Linkers Hedged	0.40%	5.58%	5.34%	5.86%	0.91	0.63	0.52
Lehman Aggregate	8.75%	7.33%	5.55%	3.57%	1.55	0.29	0.12
JPM Global Nominals	-1.50%	6.68%	7.00%	9.01%	0.78	0.44	0.34

*as of 06/30/2009

RETHINKING FIXED INCOME

In rethinking fixed income, we are helping investors optimize their use of fixed income by stepping back and examining the full spectrum of investment possibilities, based on their needs and constraints, to tailor a strategy most suited to their goals. We start by identifying and parsing the risks that will best meet their needs; then we draw upon the toolkit of available securities and investment techniques to construct a customized portfolio.

Rethinking fixed income means:

- Taking a creative approach to fixed income management—one that fully exploits the wealth of possible investment vehicles, approaches and market inefficiencies within the client's investment parameters.
- Taking an approach to active management that is explicit about parsing risks; that estimates the impact of active bets; that exploits relationships within the broader fixed income asset class (through such techniques as overlays); and that utilizes multiple sources of risk through a budgeting process.
- Reexamining benchmarks to identify the one most aligned to the client's purpose, rather than arbitrarily accepting conventional benchmarks, which often have little bearing on the investor's investment goals.
- Fitting the investment strategy to the investor, not vice versa.

