VANDERBILT Ave.
ASSET MANAGEMENT

3rd Quarter 2009

Estimates for GDP growth for the second-half of 2009 are in the 2%-3% growth range. Second-quarter real GDP (-0.7%) was significantly improved from the previous two quarters (-6.4% and -5.4%). The financial crisis of 2008 has resulted in an economic outlook which is bleak and quite anemic for growth. The US faces an economy in which consumers are saving rather than spending (Gibson Paradox). The US business sector is still quite timid and unwilling to commit to long-term fixed investments. The bottom line is one where income investments are favored over risk taking. A continued weak labor market will weigh on consumer confidence, income and spending resulting in a sub-par recovery. September unemployment was 9.8% and expected to be over 10% in the coming months and stay over 9% through 2010. Consumer balance sheets remain stressed due to stock market and housing declines combined with excessive debt burdens. While 2009 year-to-date gains in the equity market have been outstanding they still do not make up for the damage done in 2008. Simple math indicates that if the market is down 40% for one year it takes a 67% gain to break even. Consumer deleveraging will be an ongoing process that will take time and serve as a retardant to economic recovery. As the economy stabilizes a temporary period of inventory rebuilding will boost economic activity; however, a viable and durable recovery is not likely without the participation of consumers. Credit restraint on the part of both borrowers and lenders will hold back growth thereby creating economic disappointments that will likely result in additional volatility. Potential inflation should remain under control given the large amount of slack in both labor markets and manufacturing capacity. Productivity, an important economic metric, has grown (up over 6% annualized in the second-quarter) due to cost cutting by the corporate sector combined with economic stabilization. The government deficit remains a long-term problem. It is expected to total $9 trillion over the next decade including $1.6 trillion for both this fiscal year and next year. This is equivalent to 11.2% of GDP-a figure not reached since World War II. Looking forward, it will be challenging to return the accommodative fiscal and monetary policies to a normal stance. The odds favor an erratic expansion-good quarters followed by disappointing ones.

The Federal Reserve maintained its accommodative monetary policy during the quarter. While it is premature to change policy now, the Fed at some point will have to communicate a clear strategy for shrinking its balance sheet and restoring interest rates to more normal levels. Bernanke recently said it is likely the recession has ended but it could be months before unemployment drops significantly. He said the consensus of forecasters was for moderate economic growth for the remainder of the year and next as credit markets thaw, consumer confidence takes time to heal and the Federal government begins to unwind the stimulus programs. He said the economy would begin an unusually slow recovery in the second-half of 2009 and pick up speed only gradually in 2010. He repeated the Fed will keep the benchmark overnight rate at virtually zero "for an extended period." Continued subdued inflation for the foreseeable future will give the Fed the latitude to maintain ease. Bernanke has been nominated for another term and it is likely his major challenges will be the normalization of monetary policy and protecting the Fed's independence vis-à-vis Congress. It is likely financial stability has assumed greater importance to the Fed versus the past and they will more closely monitor future asset and credit bubbles.

During the third quarter, interest rates declined across the US Treasury yield curve. Slightly greater rate declines occurred as maturities lengthened. As a result, the yield curve became modestly flatter versus the beginning of the quarter:

	30-Jun	30-Sep	Change
3-monthTreasury Bills	0.18	0.11	-0.07
6-month Treasury Bills	0.34	0.17	-0.17
2-year Treasury Note	1.11	0.95	-0.16
5-year Treasury Note	2.56	2.31	-0.25
10-year Treasury Note	3.53	3.30	-0.23
30-year Treasury Note	4.33	4.05	-0.28
10-year vs. 2-year	2.42	2.35	-0.07

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Mortgage-backed securities (MBS) provided excess returns versus their US Treasury benchmark of positive 112 basis points for the third-quarter. The Federal Reserve's $1.25 trillion program implemented at the beginning of the year to purchase MBS continues to run smoothly, purchases year-to-date have been $885 billion. The Federal Reserve has announced that the program has been extended from December 31, 2009 to March 31, 2010. These purchases have helped to lower thirty-year mortgage rates to approximately 4.8%.

The Federal Reserve's purchases of MBS continue to exceed net issuance resulting in a negative 5 option adjusted spread (OAS) on the current coupon. While monthly purchases will be reduced from previous levels in order to meet the $1.25 trillion target over the next six months, net issuance is not expected to exceed purchases until the second-quarter of 2010. MBS rolls continue to trade well offering an attractive carry and yield pick-up versus comparable US Treasury issues.

In light of the Federal Reserve's continued support of the mortgage market through the first-quarter of 2010, we expect MBS spreads to remain range bound in the near term. We continue to be underweight higher coupons as buyouts resulting from loan modifications will likely hurt performance. As we move into 2010, we will likely reduce our MBS exposure. Spreads will move wider as the Federal Reserve exits the MBS market.

Investment grade corporate bonds continued the record setting pace for performance begun in the second-quarter of this year. Third-quarter excess returns were 498 basis points for the Barclays Credit Index. This return is second only to the 1178 basis points excess return in the prior quarter. Those credits that were punished most during the latter part of last year and early this year were rewarded most. Thus relatively lower quality, higher duration securities such as Telecom Italia (Baa2/BBB) maturing in 2038 and Jefferies Group (Baa2/BBB) maturing in 2036 were the best performers in the portfolio. Higher quality securities lagged, while still generating positive performance. Currently, corporate bond holders receive an additional 198 basis points of yield on average relative to US Treasury bonds. This represents less than the 483 basis points to start the year, but still slightly more than the 181 basis points investors received to start 2008.

Record performance from corporate bonds is being met with record issuance. Most industrial issuers entered last year's crisis with relatively strong balance sheets on a leverage and interest coverage basis. However, this year many companies are boosting liquidity (another important fundamental variable we monitor) after being reminded in 2008 that they cannot presume they will have access to funding in times of extreme volatility. $510 billion net new issuance has entered the Barclays debt indices. $313 billion in the credit index alone. (The rest was issued in 144a, floating rate notes or below investment grade form.) The $313 billion represents $25 billion more than the previous record set in 2007, and we still have a quarter left in the year. Undoubtedly, some of the issuance represents debt that would have been brought to market in 2008 if the market had not shut down. JP Morgan reports that liquid assets as a percentage of total assets are at a multi-year high, with cash increasing 30% over the past year. The risk is that if volatility remains low for an extended time, this cash will find a use in the way of additional leverage via mergers and acquisitions, share buybacks and increased dividend payouts.

Given the record setting performance and supply over the past couple quarters, the above mentioned risk of high cash balances, and mixed economic data, we would expect performance in the corporate bond sector to level off going into the fourth-quarter. Bond spreads remain attractive on a historical basis, particularly in the financial sector, but much of the outperformance from spread tightening is behind us. We would expect to reduce some of the overweight to corporate bonds that the portfolio has had throughout the year. Within this context, there remains ample opportunity to participate in new issuance premiums and find relative value in the secondary market via intensive credit analysis.

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