ADVISER INVESTMENTS

Fixed Income Market Commentary

March 2011

Cooler Heads Prevail

Key Points:

- Political change in the Middle East / North Africa makes investors reassess.
- Investors still want some risk and one area they still favor is high yield bonds.
- The municipal bond market sees an expected rebound and diminished outflows as cooler heads prevail.

In February there were several items that might have focused investor attention away from equity based asset classes and toward the bond markets. To a degree that is what happened, though not necessarily with the end results one would expect. Some of the news out of North Africa and the Middle East looked a bit concerning and that sparked a renewed demand for bonds. That demand though, was not enough to put Treasuries into positive territory and the asset class closed in the red, though just barely, down 0.07%. I was also somewhat surprised that the equity markets as measured by the S&P 500 were as strong as they were, up 3%+. I had expected geopolitical tensions would be more of a drag on equities given their strong run-up in recent months.

Other investor concerns involve the recent spike in oil prices (above $103 per barrel at the time of this writing) and the economic impact it may have on our economy. We believe and agree with Fed Chairman Bernanke that, for various reasons, the recent price increase is not likely to have a major negative impact on inflation or growth as long as the increase is not meaningfully higher and turns out to be temporary. For greater detail on this topic you should look at Rusty's monthly piece entitled "The Impact of Higher Commodity Prices."

In the Credit markets we saw no slow down at all. Investment grade rated corporate bonds returned 0.72% for the month. This is an area we participate in for our individual bond accounts, and it is good to see that, even within the low rate environment, we are still able to see positive returns. Speculative grade rated High Yield debt returned 1.31% with the more risky Caa component returning 1.51% for the month. This "junkier" component is now handily outpacing every other fixed income asset class on a year-to-date basis, up 4.48%. Don't be lulled into a false sense of security, though. The default rate does remain low, but there were a few more defaults during the month. Among them were a couple of well known names including Border's Group book store and Sbarro pizza shops. There have been six corporate defaults so far this year.

In the Municipal bond market it appears as though investors finally got their wits about them and returned to the asset class with enough demand to end the month with a positive return of 1.59%. We anticipated this rebound and it helps snap a five month long losing streak. A couple of factors contributed to this performance including a very light calendar of new issues for investors to choose from, the absence of bad news and investors doing what they should – taking advantage of the better price environment after the asset class was beaten up a bit in prior months.

New issue volume dropped significantly during the first two months of the year, seeing a 52% decline according industry trade journals. Issuers, many of them savvy enough to recognize that it was not worth it for them to price deals in the negative environment, pulled deals or delayed plans for financings if they could. Additionally, while outflows from muni funds continued, those outflows slowed down somewhat, taking the heavy selling pressure off the markets.

The muni market does still have a few dark clouds hanging over it though as municipalities continue to wrangle with items we have discussed in the past (budget imbalances, lower tax revenues and employee union negotiations). Also, the year's first bankruptcy filing comes to us from Boise County Idaho and it has absolutely nothing to do with economic challenges I mentioned above. The county, which does not have municipal bond debt outstanding, was forced to file for bankruptcy after a jury awarded a developer $4+ million. The legal action stems from a dispute over a substance abuse treatment center the developer wanted to build and the county's conditional attachments to the approval process. The county's annual budget is less than $10 million and the powers that be say they cannot satisfy the award and run the county, so they took the steps necessary to be able to continue to provide basic services. Incidentally, the state's capital city of Boise (population ~ 206,000) is not located in Boise County. The county's population is fewer than 8,000 people. I bring up this story because it is some of the headline risk I have referred to in the past, though to be perfectly clear, I was not thinking about bankruptcies due to a municipality losing a court case. Stay tuned.

Barclays Fixed Income Index Returns Through 2/28/11

	Duration	Feb.	YTD '11	Return '10	Return '09	Return '08
US T-Bill Index	0.32	0.02%	0.03%	0.22%	0.37%	2.44%
US Treasury Index	5.31	-0.07	-0.10	5.87	-3.57	13.74
US TIPS Index	5.72	0.86	1.05	6.31	11.41	-2.35
US Aggregate Bond Index	5.10	0.25	0.37	6.54	5.93	5.24
US Govt / Credit Index	5.46	0.23	0.31	6.59	4.52	5.70
US Credit Index {A2}	6.39	0.72	0.93	8.47	16.04	-3.08
US High Yield Index {B1}	4.21	1.31	3.55	15.12	58.21	-26.16
Caa component	3.48	1.51	4.48	16.43	90.65	-44.24
Emerging Market ($$) {BA1}	6.38	0.48	0.20	12.84	34.23	-14.75
Municipal Index	8.44	1.59	0.84	2.38	12.91	-2.47
Municipal Index - 5 Year	3.93	0.64	0.31	3.40	7.40	5.78

Source: Barclays Capital

Christopher Keith
Senior Vice President
Fixed Income Manager