LOM ASSET MANAGEMENT
The LOM Building • 27 Reid Street • Hamilton HM11 • Bermuda • Telephone (441) 295- 6999 • Fax (441) 295-0135

LOM Fixed Income Commentary

"Don't fight the Fed" – Ancient Wall Street Proverb

Despite this time tested adage, the bond market seems intent on doing just that. In one corner, key bond players believe that the economy is growing, that inflation is a threat, and that the Federal Reserve's insistence on anchoring short-term interest rates is about finished (or not working). In the other corner, Fed policymakers appear to favor a more aggressive approach to suppressing rates in order to spur spending (and ultimately employment) and find it puzzling that the bond market and long-term rates are resisting their lead.

The outcome of this battle will have major implications on the economy throughout 2011. Unlike other western central banks (ECB and BOE specifically), the Fed is implicitly responsible for fighting not only inflation but also unemployment. The current 9.4% (as of December) unemployment is a main contributor to the current bias to extended quantitative easing despite the fact the US deficit is growing at alarming rate and inflation is rising due to the modest recovery, higher commodity prices and a weaker US Dollar.

The recent elections will also have an implication on these policies as Republicans won many of their seats on a fiscal campaign that should curtail spending and future subsidies. As a result, the Fed, the President and state legislatures will likely come under intense pressure to shift their focus away from quantitative easing and adopt European-like measures of austerity to handle the recession's hangover. However, this will be hugely unpopular in the US since it will require a reduction in household expenditures which will result in a reduced standard of living.

This idea may also be rebutted by the Fed as well as some economists who will argue the recession is purely cyclical and that the old remedies of stimulus and loose monetary policies are quite adequate to push the cycle along to its expansionary phase. However, if the Fed is incorrect and loses this battle, look for long term interest rates to rise more than anticipated. This, in turn, is likely to lend momentum to the growing movement to replace the US Dollar as a global reserve currency with a basket of currencies.

Conversely, if the Fed wins this battle and successfully manages the delicate balance of increasing spending without creating a much weaker dollar or high inflation, we would expect the monetary policy to change slowly throughout 2011. In this case, we would look for modestly higher overnight rates by the end of 2011, continuing into 2012. If this occurs, we feel that yield curve (2 to 30 years) will revert to a normalized level (see chart 1).

Chart 1 Source: Bloomberg LP	Current Yield (01/10/11)	10 Yr. Moving Average Yield	Price Appreciation as of 12/31/11	Total Return as of 12/31/11
2 Year	0.58%	2.69%	-2.11%	-1.50%
3 Year	0.96%	3.02%	-3.70%	-2.96%
5 Year	1.92%	3.46%	-5.86%	-3.80%
10 Year	3.28%	4.16%	-6.16%	-3.41%
30 Year	4.46%	4.76%	-4.67%	-0.32%

Either way, we expect 2011 to be a challenging year for the bond market, regardless of the Fed policy and we expect returns to be much lower (potentially negative) than in recent years. Being said, we feel we will be able to position our portfolios in areas that will provide an excess return versus the benchmark while minimizing overall risks.

SECTOR IN FOCUS: Municipal Bonds

"The reports of my death have been greatly exaggerated"- Mark Twain

The municipal market will continue to come under scrutiny as large states battle with budget deficits and underfunded pensions. In the fourth quarter of 2010, pundits and media outlets began to publicly debate the potential for rising municipal defaults in 2011. As a result, municipal bond funds saw record redemptions and municipal prices, while generally in-line with US Treasuries prices, fell across the board.

It is important to remember that the municipal bond market is not immune from the stresses of the weaker economy. It is equally important to understand why LOM continues to utilize two types of municipal bonds – General Obligation bonds and essential Revenue bonds – which we believe are ultimately safer than corporate bonds, while still providing good value compared to like-maturity Treasury bonds.

The reasons are quite simple and relate to how issuers service their debt. Corporations rely on their strong balance sheets to service their debt and, in general, do not have alternative means of repaying lenders if their ledgers weaken. Municipalities on the other hand have several ways of servicing debt. General Obligation municipal bonds are backed by the full faith and credit of the authority that issued the bonds; if necessary, the municipal issuer is typically able to raise taxes to service debt. While this may not be popular amongst those who live in the municipality, the issuer is contractually committed to doing so.

Another type of municipal bond that is considered very safe is an essential Revenue municipal bond (e.g., a bond issued for water, sewer or utility projects). These bonds are backed by the revenue stream generated from the services provided by the issuer. In these cases, the issuer has the ability to adjust rates for their services to make timely repayments of debt. In addition, many General Obligation and Revenue bonds are also backed by public insurers which add another layer of protection against default.

Ultimately, even the General Obligation market is not immune from occasional defaults. To date, the default of Orange County, California in 1994 is the largest on record. While this event shocked the markets, many people do not know that most holders of the Orange County's debt recovered 100% of their principal. In addition, the county was able to regain its investment grade credit rating within three years. These are two feats that would be almost impossible by a corporate issuer who would be forced into general liquidation, leaving the cupboards bear and likely repaying its bond holders only a fraction of original face value.

We believe the psyche of the market will provide buying opportunities in the months to come. We believe the recent calls for a municipal market Armageddon are overblown and while defaults may increase slightly (most likely from NON-essential revenue bonds), the municipal market will remain a viable tax efficient tool for investors. As a result we continue to favor a reversion-to-the-mean trade in this market. The historical average yield on a 10-year General Obligation bond is 80% of that of a 10-year Treasury bond (a.k.a. municipal / treasury ratio). This ratio is currently above 100%. Hence, in addition to their tax benefits, municipal bonds also provide portfolios with the potential to capture excess yield and outperform the Treasury market.

STRATEGY IN FOCUS: Investment Grade Corporate Bonds

SELL: Lower fixed coupons in the 2-5 year portion of the curve.
BUY: Floating Rate Notes (FRNs) and high coupon notes in the 5-7 year portion of the curve.

While both of our predicted outcomes point to higher rates, we still feel there will be opportunities for the market to perform in 2011. Below we focus on two corporate bond strategies that we are currently implementing in clients' portfolios.

As stated in our October commentary, we feel that the improving economy should lead to a normalization of interest rates in 2011. As a result, our short, intermediate and core mandates are employing barbell strategies to maintain durations that continue to be shorter than their respective benchmarks.

We feel that the short side of the barbell can be best achieved by owning floating rate notes ("FRN"). FRN's are a natural hedge against potential higher rates as they have coupons that reset periodically based on a pre-specified benchmark, usually 3 month LIBOR.

While these instruments provide protection against rising interest rates, they tend to pay lower yields than fixed rate notes. As a result, we are selling 2 to 5 year corporate bonds and replacing them with 2 to 4 year FRN's. Although the U.S. Federal Reserve has been steadfast in keeping short term rates low, we feel rates will be rising for the next two years. Hence, this area of the curve offers the most value. Ultimately, these bonds should provide alpha without adding risk.

We've all seen the headlines about the higher interest rates that threaten to produce negative returns for the bond market as a whole. FRNs, with their regular rate resets and their naturally low durations, are the best fixed income vehicle for mitigating this interest rate risk. Graph 1 reveals how the spread between 10 year US Treasuries and 3 month LIBOR are at historically wide levels (currently 315 bps).

The graph also illustrates two important facts:

- Rate corrections are always swift.
- A flat-to-inverted curve is almost always followed by an economic slowdown, or outright recession, as well as lower interest rates across the board.

Graph 1:
Spread Summary
Source: Bloomberg LP
As of 1/7/11

Last	315.082
Mean	131.236
Off Avg.	183.846
High 04/05/10	369.632
Low 12/20/00	-146.31

Accordingly, we will look to reduce our FRN positions when the curve flattens.

Floating rate notes are typically issued by finance companies, e.g., banks, brokers and insurance companies. This fact should ultimately enhance our returns as we feel that the finance sector will continue to outperform in the near term as the initial stages of interest rate increases are positive events for three primary reasons:

- economic growth decreases imbedded asset quality issues;
- economic growth should increase product demand for M&A loans and insurance products;
- Financial spreads are still significantly wider than non-financial spreads; hence economic growth should create further compression.

Although we have stressed the potential negative price return to illustrate the effect of higher yields on price valuations, *total return* is the overriding measure of bond performance. As such, the coupon of a bond becomes a significant consideration, i.e., the higher the coupon, the greater the difference between *Total Return* and *Price Return*.

As a result, to achieve our target duration (via our barbell strategy) we advocate buying high coupon corporate bonds maturing in 2016 and 2017. Combined with the low duration positions of FRNs, this will allow the portfolios to access the steepest part of the curve which offers a more attractive yield; the 7 year currently offers yields more than 200 bps higher than the 2 year.

Consider the following example, which highlights the performance of two similar bonds with different coupons:

- JP Morgan (JPM) 4.65%, maturing in July 2018
- JP Morgan (JPM) 7.25%, maturing in February 2018

Source: Bloomberg LP	Yield Shift	Spread	Yield	Coupon	Duration	Convexity	Current Yield	Price	Price Movement	Total Return
Starting Level		180	4.30%	7.25%	5.61	0.38		$117.75		
JPM 7.25% 02/2018	0 bps	180	4.30%	7.25%	5.61	0.38	6.16%	$115.54	-1.88%	4.30%
	+50 bps	180	4.80%	7.25%	5.61	0.38	6.16%	$112.71	-4.28%	2.02%
	+100 bps	180	5.30%	7.25%	5.61	0.38	6.16%	$109.96	-6.62%	-0.22%
	+150 bps	180	5.80%	7.25%	5.61	0.38	6.16%	$107.29	-8.88%	-2.42%

	Yield Shift	Spread	Yield	Coupon	Duration	Convexity	Current Yield	Price	Price Movement	Total Return
Starting Level		170	4.32%	4.65%	6.40	0.46		$102.09		
JPM 4.65% 07/2018	0 bps	170	4.32%	4.65%	6.40	0.46	4.55%	$101.84	-0.24%	4.32%
	+50 bps	170	4.82%	4.65%	6.40	0.46	4.55%	$99.06	-2.96%	1.65%
	+100 bps	170	5.32%	4.65%	6.40	0.46	4.55%	$ 96.37	-5.60%	-0.97%
	+150 bps	170	5.82%	4.65%	6.40	0.46	4.55%	$ 93.77	-8.15%	-3.54%

Aside from the duration and convexity differences between the two bonds, the *Current Yield* (i.e. 12- Month Carry) is the greatest differentiating factor over this hypothetical 12-month total return scenario in which the higher-coupon bond produces a better return in all rising rate scenarios.

While it is important to acknowledge that many clients have a general dislike of high premium priced bonds, we feel the current environment in the investment grade universe should produce a low level of defaults making these bonds more palatable.

For more information on the LOM Asset Management Fixed Income strategies, please contact your relationship manager at LOM or call (441) 295-6999.