

# Market Commentary

## U.S. Fixed Income

As of June 30, 2010

H O L L A N D  
C A P I T A L M A N A G E M E N T

### Bond Market Review

The Barclays Capital Aggregate Index, a measure of the overall domestic bond market, generated a total rate of return of 3.49% for the second quarter. Credit markets initially looked resilient at the onset of the European debt crisis. But as the crisis intensified, corporate spreads gapped out significantly as investors became risk adverse. Hardest hit were the financials and pipelines resulting from continued turmoil in Europe and from the oil spill in the Gulf of Mexico. Defensive sectors such as utilities, healthcare and aerospace & defense turned in the best performance over the three month period. Longer maturity corporate bonds performed better than their intermediate maturity counterparts. Limited supply of new issuance, strong corporate balance sheets and plenty of investor cash sitting on the side lines should set the stage for outperformance in the third quarter.

Mortgages held their own as demand from domestic and foreign investor's outpaced supply keeping spreads at very tight levels. Moreover, the sector benefited from the flight to safety as mortgage securities have the implied government backing. There is a risk of a mini refinancing wave as mortgage rates are near historically low levels. However, the refinancing risk may be less than expected as many homeowners who were eligible to refinance did so last year when rates were near these levels. Twenty year collateral which represents 2.7% of mortgage collateral outperformed the fifteen and thirty year collateral sectors. The 15 year collateral sector is experiencing investor resistance as the premiums for all coupons continue to rise due to the decline in overall

yields. The mortgage sector remains expensive as spreads are extremely tight and are near the bottom of their long-term historical range.

The Government Related sector consists of 74% of U.S. Agency debt, 8% of Local Authorities (taxable municipals including Build America Bonds (BABS)), and 9% each of Sovereign and Supranational debt. U.S. Agency performed relatively well compared to the other subsectors and generated no excess return for the period. Although issuance will stay high as the agencies purchase delinquent mortgage loans, the explicit government guarantee will keep spreads at a narrow range versus the Treasury curve. Callable agency bonds have done well offering yield pickup over bullet agency bonds as well as mortgage-backed securities. However, Local Authorities generated 299 basis points of negative excess returns in response to the concerns that the BABS program will be allowed to expire at the end of the year. Sovereign bonds generated 369 basis points of negative excess as concerns continued to be focused on the state of the Euro zone. Supranational bonds generated 49 basis points of negative excess return in response to the Sovereign sector issues.

Commercial Mortgage Backed securities continued to post positive excess returns but substantially less than the first quarter. This sector continues to benefit from spreads gapping in from the peaks reached during the financial crisis. The fundamentals for this sector continue to deteriorate as vacancy rates remain elevated. However, there are early signs that the pace of deterioration may be moderating. The Asset-Backed sector generated the smallest negative excess return for the period. This sector

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weighting is approximately .28% and is a good alternative to corporate bonds. Issuance in this sector has been extremely limited keeping spreads tight.

### Portfolio Review

For the second quarter, the fixed income portfolio generated a return of 3.33%, gross of fees compared to the Barclays Capital Aggregate Index of 3.49% for the period. The biggest detractor to performance came from the underweighting in the U.S. Treasuries as the portfolio was overweighted in spread sectors. In addition mortgages were not additive due to the accelerated prepayment experience in the REMIC holdings as FNMA bought out its 120 day delinquent loans from its guaranteed portfolio. In addition, the mortgage portfolio which has a higher concentration of fifteen and twenty year collateral for extension risk protection did not do as well as thirty year collateral where demand was higher due to lower prices. The most additive to performance was the significant overweight in the Government Related sector. Corporates were additive as longer dated credits rode along the rally in the ten and thirty year Treasuries. In addition, the overweight in industrial credits significantly contributed to the sectors returns offsetting the underweighting in the utility sector which did quite well due to its defensive characteristics. Moreover, the portfolio had limited exposure to those credits that were negatively impacted by the BP oil spill. Portfolio duration averaged 90% of benchmark duration or 4.1 years. Portfolio duration was heavily influenced by declining yields during the period which shortened mortgage duration and raised expectations that

callable agency positions would indeed be called. Mortgages duration which can be volatile month to month shortened from 3.83 years at the start of the quarter to finish at 2.29 years, down approximately 1.5 years.

During the quarter, sector weightings did not significant change. Maturities were reinvested in like sectors. To take advantage of the steep yield curve thirty year corporates were added during the period. In addition, callable and step up agency issues were purchased with call proceeds to add yield compared to agency bullets and MBS securities. Mortgage prepayments proceeds were reinvested in fifteen and ten year collateral on market pull backs in April and May and in a new issue credit card asset back security that was attractively priced with a three year average life was added in June.

With yields expected to remain low for some time it will be difficult to find opportunities to reinvest call proceeds and mortgage prepayments. We expect spread sectors to remain overweighted into the third quarter and expect to trade on market bull backs when they occur. For now there is a tremendous amount of demand for yield and this will keep rates low and spreads tight for the some time.

### Economic and Interest Rate Outlook

The U.S. economy grew at a 2.7% annual pace in the first quarter of 2010, a much slower pace compared to the 5.6% gain in the fourth quarter. However, growth remains supported by strong advances in business inventories as restocking continued from the previous quarter. In addition, consumer spending which accounts for about

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two-thirds of U.S. economic activity rose at a 3% pace, the largest advance in three years, compared to 1.6% in the previous quarter. Business spending on equipment and software advanced at an 11.4% rate as businesses continue to replace worn out equipment and upgrade their technology. The drag on growth came from exports whose growth was eclipsed by a rise in imports, resulting in a higher trade deficit that subtracted from the economy's performance. Moreover, the drop in state and local government spending also pulled down growth as spending fell at the sharpest pace since 1981 as budgets had to be balanced. The State's fiscal crises are unlikely to go away any time soon as long as the national economy remains fragile.

Based on May and June economic data, the U.S. economy has hit a soft patch in the second quarter. Manufacturing and non-manufacturing activity continues to expand but data suggests the pace has begun to ease. Housing activity has fallen sharply following the expiration of the homebuyer's tax credit. And on the labor front, initial jobless claims have ticked up and June's employment report showed earnings and hours worked ticked down while the labor force participation rate fell by 0.3 percentage point. Outside the U.S., the Euro zone crisis continues to intensify and China's economy is beginning to show signs of slowing down. We believe the U.S. recovery, albeit at a sub par pace for the next few quarters, will continue as interest rates remain at historically low levels. However, the key to getting the economy to expand at or above its trend rate will be the creation of a lot of good paying jobs. The government can not make businesses hire if they do not want to. Perhaps the best approach to get Americans back to work is to exploit opportunities in

rebuilding the nation's infrastructure. Of course this requires additional spending by the government at a time when there is a lot of talk about belt tightening to control the budget deficit and rising debt levels. However, fiscal policy is set to tighten next year as the Bush tax cuts expire, particularly the top marginal income tax rate. And conservatives in Congress are blocking extensions to unemployment benefits and emergency aid to the States. The risk here is that if fiscal tightening occurs prematurely it could derail the fragile recovery. At the G-20 summit held in Toronto in late June, the leaders of the advanced economies agreed to shrink their budget deficits by half or more by 2013. The pressure is on the U.S. to follow suit.

At the June FOMC policy meeting, the Fed acknowledged that the economy was softer and that the European debt crisis may have a negative impact on the U.S. economy. Importantly, the Fed also stated that "underlying inflation has trended lower." With an economy growing at a sub par pace with lots of excess capacity, deflationary pressures are a concern for the Fed and for the economy. If consumers delay purchases because they expect lower prices, then declining demand will only worsen a downturn. To keep the threat of deflation at bay, the Fed will keep the federal funds rate at near zero for some time.

The bias for higher interest rates ended in April as the European debt crisis pushed investors towards safety, resulting in lower Treasury yields and wider spreads for corporates, agencies and mortgage backed securities. However, by June, the lower Treasury yields were driven more by economic weakness rather than risk aversion. Consequently, Treasuries were the best

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performing sector for the quarter, particularly the thirty year maturity as the yield curve flattened a good 40 basis points between the two year and thirty year maturities. The bull flattening reflects the markets view that inflationary pressures are non-existent as an outcome of weak demand and excess capacity.

### Fixed Income Investment Team



**Laura J. Janus, CFA**  
*Chief Investment Officer  
& Portfolio Manager — Fixed Income*

Ms. Janus is a founding partner of Holland Capital and serves as the Chief Investment Officer for Fixed Income and as the Fixed Income Portfolio Manager. Ms. Janus holds primary responsibility for fixed income research and trading for the firm. She has more than 40 years experience managing taxable fixed income assets. Prior to forming the firm in 1991, Ms. Janus was a member of the investment department at Mutual Trust Life Insurance Company and was responsible for credit research and management of a \$200 million fixed income portfolio comprised of short term instruments, private placements, public bonds and common and preferred stock. Later she was elected Treasurer, which added responsibilities in the areas of banking relationships, cash flow management, five-year projection plans and budgets. Ms. Janus holds a B.S. in accounting from Western Illinois University. She currently serves on the WIU Advisory Board for the College of Business and Technology, the President's Advisory Board, and the WIU Foundation Board. In 2008, she was honored with the Outstanding Alumni Award from the WIU Department of Accountancy. Ms. Janus received the Chartered Financial Analyst designation and is a member of the CFA Society of Chicago and the CFA Institute.



**Janet S. Henry, CFA**  
*Senior Fixed Income Analyst*

Ms. Henry is a Senior Fixed Income Analyst whose primary responsibilities at Holland Capital include the fundamental research and valuation analysis of fixed income. She has 31 years investment experience. Prior to joining Holland Capital in 2000, Ms. Henry was a founding partner with Heartland Trading Group, a Commodity Trading Advisor. Previously she was with Aon Corporation, where she was a Senior Portfolio Manager in the asset management division and researched and managed \$2 billion of domestic corporate bonds and structured mortgage-backed securities in fixed income portfolios. She earned an M.B.A. from the University of Chicago and a B.A. in history from DePauw University and is a member of The McDermond Center Board of Advisors. Ms. Henry received the Chartered Financial Analyst designation in 1989. Ms. Henry is a member of the CFA Society of Chicago, the CFA Institute and the University of Chicago Women's Business Group.

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