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Portfolio Commentary

By Jill King, Vice President, Senior Portfolio Manager

The US economic recovery and the overall tone of the market has deteriorated since the end of June. The housing sector, which exhibited signs of recovery during the spring, has faltered with the expiration of the new home owner credit. High levels of unemployment continue with July's non-farm payroll number disappointing with a loss of 131,000 jobs versus an expected loss of 65,000 jobs. June's non-farm payroll number was revised to a loss of 221,000 jobs versus the announced loss of 125,000 jobs. Initial jobless claims continue to disappoint with increased numbers of first time claimants. Personal income and personal spending were flat for the month versus expectations of small growth in both areas.

The Fed met this week and again kept interest rates at 0 - .25 basis points and reiterated the "extended period" language in their statement. The FOMC statement was significantly more dovish than the one released on June 23rd and revealed the Committee's increasing concern about the weakening economy. They announced that they "will keep constant the Federal Reserve's holdings of securities at their current level by reinvesting principal payments from agency debt and agency mortgage-backed securities in longer-term Treasury securities." This move is at the minimum symbolic; and at most it opens the door for a renewed round of quantitative easing "QE". The shift in policy reflects an unambiguous downshift in the Fed's assessment of both the current state of the economy and the outlook for the economy going forward. Looking at Fed Fund Futures, a rate hike to 50 bps is not priced in until December 2011. The 2-year Treasury note hit an all time low yield of .496% on August 6th, and the 10-year Treasury reached an 18-month low yield of 2.71% after the FOMC announcement.

There are a few highlights in the market. First repo levels have normalized paying 15 – 20 basis points overnight, making it less damaging to hold liquidity. There was concern, before the release of the FOMC statement, that the Fed would remove the "IOR", interest on reserves, that they pay member banks. (Although most pundits felt this move was unlikely, if instigated it would have a negative impact on overnight repo rates bringing them down as much as 10 basis points.) In addition, we continue to find value in the Tier 2 Commercial Paper "CP" space, with overnight rates ranging between 60 – 75 basis points. We also invested in term CP issued by Empire Electric at 1% annualized return for a 30 day investment. The new issue corporate bond market picked up steam recently with \$30.9 billion being issued last week versus \$16.2 billion issued during the week of July 30th. The activity in the new issue market creates opportunity as total return bond funds sell short dated corporate notes to make room for new issues. We have taken advantage of this in accounts that allow corporate notes. The new issue agency market has been lackluster, we continue to find secondary agency pieces that provide enhanced yield compared to levels on new issue product.

While the short end of the curve continues to be constrained offering little in terms of yield, we remain vigilant in our quest to provide alpha while maintaining our commitment to prudent investment of client's trading capital.

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