

June 2010

## Portfolio Commentary

By Amy Walkington Haney, Portfolio Manager

The second quarter of 2010 has finally concluded and will not be remembered fondly by most investors. Market participants witnessed a sovereign debt crisis, followed by a flight to quality, miserable equity performance, and one of the largest oil spills in history during the course of Q2 2010. Disappointing economic data trickled in throughout the month of June pushing back expectations for Fed interest rate hikes and driving treasury yields to their lowest yields of the year. The two-year note ended the month yielding .60%, 16bps lower for June while the ten-year treasury ended the month yielding 2.93%, after reaching 4% just a few short months ago. On a positive note, 3-month Libor stabilized during June averaging 54 basis points for the month, signaling improved confidence in European banking.

To say that the labor and housing data continue to fall short of expectations would be an understatement. May's nonfarm payroll report showed employers added fewer jobs than economist forecast. Employers added 431k jobs, just 41k private payrolls, while the median forecast was for an addition of 536k jobs. The private payroll number was particularly disappointing because the majority of the gains were due to temporary census jobs. The continued weakness in the labor market was joined by dismal results in the housing sector. Housing starts fell 10% to 593k, the largest monthly decline since March 2009, indicating the housing market will struggle without government incentives. Building permits, a sign of future construction, unexpectedly fell 6% to a one-year low. Single family starts suffered the largest drop since 1991. And if those numbers weren't bad enough, purchases of new home fell 33% in May to an annual pace of 300k, the lowest in data going back to 1963. However, June was not all doom and gloom. Industrial production rose 1.2%, durable goods orders ex-transport rose .9%, and consumer spending increased .2%, exceeding forecasts.

The Fed has made no secret of their focus on improving employment and stabilization of housing before removing policy accommodation, given inflation remains subdued. Therefore, it comes as no surprise that the tone of the FOMC statement was slightly more dovish. The June statement revealed "the economic recovery is proceeding" rather than "has continued to strengthen" in their previous announcement and housing starts "remain at a depressed level" rather than "have edged up but remain at a depressed level" before. The FOMC statement gave the market and investors confidence that the "extend period" has in fact been extended. Many economists have pushed back their forecast of Fed rate increases into the 3rd quarter of 2011. Fed fund futures don't price in 100% certainty of a 25 basis point increase in the funds rate until June 2011.

Given the flight to quality and the postponement of higher rates, we have seen agency spreads tighten. Bullet agencies do not offer much yield above treasuries, but we still see value in callable agencies and as well as step-up structures. For example, we bought an 18 month agency step-up with an initial yield of .625%, which steps in 6 months to 1% and 1.5% in another 6 months if not called. We continue to take advantage of higher commercial paper levels and wider spreads have provided some opportunities in short corporate bonds.

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