

March 2010

## Portfolio Commentary

By Amy Walkington Haney, Portfolio Manager

March witnessed an aggressive move in Treasuries with yields substantially higher than when the month began. A combination of heavy supply, uncertainty surrounding the Fed exit strategy, and funding pressure all contributed to higher rates across the curve. Treasury bill yields moved up 5-8 basis points, the 3-month T-bill ended the month yielding 16 basis points with the 1-year T-bill yielding 41 basis points. The Treasury market continued to be negatively impacted by the Fed's Supplemental Financing Program (SFP), announced in February. The two-year note ended the month yielding 1.02%, a move of 20 basis points. The program also influenced the Fed Funds effective rate, lifting REPO and commercial paper rates by 5-10bps.

Short agency securities had been trading at historically tight spreads versus comparable Treasuries. In fact, there was little to no "spread", or additional yield, offered on 1-year and shorter FHLB, FHLMC and FNMA bonds. A number of events caused agency spreads to widen to more normalized 10 – 15 basis points versus Treasuries. Contradictory comments by Congressman Barney Frank regarding the guarantee of FNMA and FHLMC contributed to volatility at the beginning of the month. Frank quickly recanted and affirmed his support for the government guarantee. Treasury also reiterated their commitment to supply an unlimited source of capital to FNMA and FHLMC through December 2012. The asset purchase program, announced by the Fed in late 2008 to support the agency and mortgage market, finally came to an end. The termination of the program contributed to additional spread widening in both agency and MBS products. On March 23rd, Treasury Secretary Timothy Geithner testified on housing finance before the House Financial Services Committee. Geithner's comments were supportive of the Government Sponsored Enterprises (GSE's), restating the government "is committed to ensuring that the GSE's have sufficient capital to perform under any guarantees issued now or in the future and the ability to meet any of their debt obligations."

As expected, the Federal Reserve's March meeting proved to be a non-event with the committee maintaining the target 0 - .25% Fed Funds rate. Federal Reserve officials repeated their pledge to keep the Fed Funds rate "exceptionally low" for an "extended period of time". Officials noted that while "economic activity has continued to strengthen" and "the labor market is stabilizing," household spending remains "constrained by high unemployment" and "housing starts have been flat at a depressed level." Positive economic data, such as strong retail sales and durable goods orders for February, along with subdued inflation and an increase in consumer confidence leaves investors cautiously optimistic. February non-farm payrolls fell 36,000 versus the predicted loss of 68,000 jobs while unemployment held at 9.7%, supporting the notion that the labor market is slowly healing.

The recent move up in yields presented opportunities in short agencies as well as commercial paper "CP". We saw attractive offerings in Tier II CP due to the increase in very short rates and, more significantly, the pending money market regulatory changes which restrict the amount of Tier II CP money market funds can own. For example, we recently purchased a one year callable agency at .60% and Commonwealth Edison (Tier II CP) paying .70% for a 7 day investment.

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