SECOND QUARTER 2013

PIEDMONT PEAKS

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Sticking with Bonds: Protecting your hard earned gains and finding new ones

Clients and the financial media apparently share a common fear: The bursting of the "bond bubble" and the calamitous upward move in interest rates. Our base case scenario does call for an increase in economic growth, which should lead to higher rates given that positive ***real interest rates*** have been the historical norm. Current levels of interest rates are more a reflection of global central bank activity and fears about the dissolution of the Euro or other exogenous factors. Ultimately, however, interest rates always become a function of economic growth, inflation, and future economic activity.

While we agree that valuations in US domestic fixed income are of the nosebleed variety, we think retrenching from the asset class is unwise as there are opportunities to play defense in the corporate credit market while unlocking some value in targeted areas that may, at times, be below the radar.

Opportunities?

What types of securities provide potential outperformance in this environment? With an eye towards capital preservation, we see three potential opportunities in today's marketplace, including:

- **Discounted floating rate notes** (FRNs) remain a solid hedge against rising rates, especially as these will increase in price as they move toward maturity. These notes generally reset to LIBOR, which tends to move higher before Fed Funds, as policymakers move slower than market rates. Therefore, FRNs could provide investors some ***capital appreciation*** while also increasing coupon income.
- **Shorter high yield paper** is a potential trade we like in this environment for several reasons. There are a number of "rising stars" poised to move from high yield to investment grade, and stable high quality high yield names that provide outsized yield relative to investment grade paper of similar tenor, but that should be less sensitive to interest rate moves. We can invest in bonds with much shorter durations and higher yields than the index. From a valuation perspective, "rising stars" tend to have upward movement in price almost irrespective of underlying market conditions.

Macro Spotlight: Housing

Driving Growth in 2013

We believe the housing market will be a driver of growth for 2013 and beyond, a trend that finally began to take hold during the second half of 2012. Ultimately, this trend should be a positive well beyond the actual contribution to GDP, given the known multiplier effects of a housing recovery. In fact, the sequential increase (quarter-over-quarter percentage change) in the residential component of GDP compared to previous recessions suggests this contribution should bolster both nominal and real GDP to levels consistent with past recoveries (see chart).

Sequential Growth (in %)

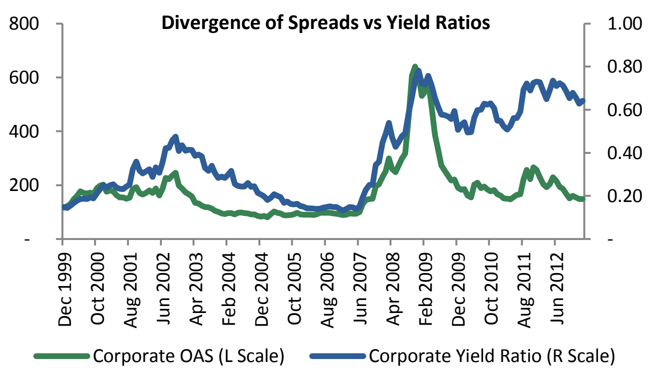
First 12 Quarters of Expansion	Residential	Consumer Spending	Real GDP	Nominal GDP
1975Q1 – 1978Q1	17.60	4.80	4.50	11.00
1982Q4 – 1985Q4	17.50	5.20	5.80	9.20
1991Q1 – 1994Q1	11.60	3.40	3.20	5.60
2001Q4 – 2004Q4	8.50	2.90	2.90	5.30
Average	13.80	4.10	4.10	7.80
2009Q2 - 2012Q2	2.60	2.10	2.20	3.90
2012	15.43	1.90	1.63	4.05

Source: U.S. Department of Commerce Bureau of Economic Analysis

- **Higher coupon "yield-to-call" paper**; whether high grade or high yield. This paper, though purchased at high dollar prices relative to maturity or call value, provides a large amount of current income to reinvest as rates move higher. Essentially, this type of paper has very deep "in the money" calls, meaning that there is a very low probability, absent a huge move in rates, that the paper will remain outstanding beyond its call date, as the company has a strong economic incentive to redeem it early. Such paper generally has 1-3 years to the first call date with final maturity extending further. The opportunities we see, however, are very short duration because of the short call date and high dollar prices.

The Best Offense is a Strong Defense

From a valuation perspective, many observers note that ***absolute*** corporate yields are quite low, and there is no arguing this point. And the risk premia investors demand to own corporate debt have continued to decline as evidenced by tightening credit spreads for a plethora of reasons, most importantly the Fed's attempt to push investors into riskier assets. These spreads, however, looks generous relative to the stingy underlying Treasury yield. These "yield ratios" are fairly high by historical standards, presenting a compelling ***relative*** investment opportunity. That is, spreads have tightened, but the historical relationship between spreads and yields has broken down. During periods of economic growth, yield ratios tend to decrease, as rates move up while spreads simultaneously move downwards. The ratios remain historically high at this point in an economic recovery, implying potential relative outperformance for corporate bonds.



Source: BofAML

Credit Quality, Low Defaults Poised to Continue

From a fundamental perspective, corporate bonds are actually reasonably attractive, especially as compared to other domestic fixed income. Default rates remain low by historical standards across the rating spectrum, and though these are predicted to rise, the forecast rates are very manageable.

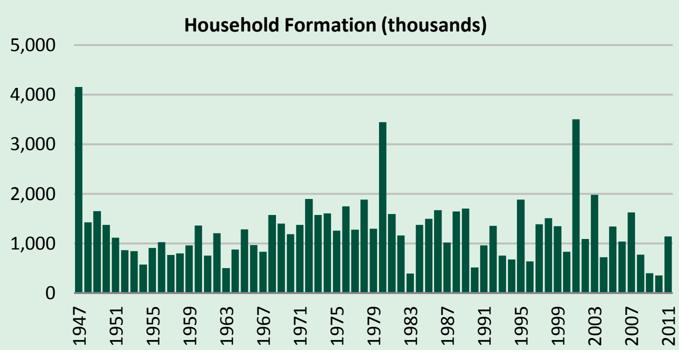
Year ending	Overall default rate (%)	Investment-grade default rate (%)	Speculative-grade default rate (%)
2007	0.37	0.00	0.89
2008	1.77	0.42	3.61
2009	4.09	0.32	9.60
2010	1.17	0.00	2.88
2011	0.76	0.03	1.73
2012	1.10	0.00	2.47
Average (since 1981)	1.47	0.10	4.22
Maximum (since 1981)	4.09	0.42	11.05
Minimum (since 1981)	0.14	0.00	0.62
Current	1.10	0.00	2.47

Source: Standard & Poors

While we have likely seen a cyclical peak in credit quality, there are no real catalysts for a drastic downturn either. Cash on corporate balance sheets remains near all-time highs, even though revenue increases and cash flow generation have slowed. This implies any further improvement in credit metrics will come from an increase in global economic growth. While we must always be alert to idiosyncratic events such as leveraged buyouts or transformative M&A, credit quality in aggregate remains

Housing affordability near generational high as indicators turn upward

All of the primary housing indicators have turned upward, including building permits, housing starts, new home sales. Moreover, we believe the sustainability of this trend is anchored within the two ***leading*** indicators of underlying demand: 1) **household formation** (see chart right), which was historically low coming out of the Great Recession, and appears to be recovering nicely, and **lack of existing supply tends to create housing demand** (see chart next page).



Source: Bloomberg

strong.

We note three main factors keeping defaults low:

1) Fed policies have ensured that corporate borrowers have access to markets and the ability to issue debt at historically low yields. This dynamic improves standard credit metrics and has pushed out maturity schedules for many companies
2) The same liquidity dynamic that has allowed companies to access the capital markets cheaply has also improved their access to bank lines and terms
3) The economic outlook continues to improve, providing another tailwind helping to stabilize credit metrics. In essence, the economy is weak enough that the Fed will not "take away the punch bowl," but not anywhere close to recessionary territory or to a point where the Fed would begin tightening credit conditions. The tactics and strategies that we enunciate above should also work even if the economic outlook deteriorates or stalls, although for different reasons.

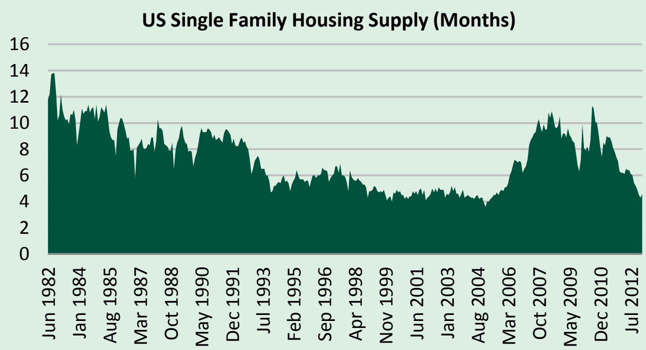
Outperformance on the Horizon?

Clearly, if our reasonably sanguine economic outlook is correct, spreads will tighten, but rates should also rise in line with improved economic growth forecasts and potentially inflationary conditions. If GDP numbers begin to look sustainably stronger, we anticipate intermediate and longer-term interest rates will begin to normalize, even as the Fed keeps short rates anchored. The 10-year note, for instance, has historically approximated nominal GDP, which is running around 4%. While we think this relationship may have changed somewhat, we still think a 10-year Treasury rate currently providing zero or negative real return is unsustainable. So, if we are set to enter a modestly upward rates environment, corporate bonds will tend to outperform equivalent duration Treasuries.

Dispelling the Common Fear

Despite the bond bears calling for decimation in bond markets, we believe fixed income investors still have places to look for yield and return. In an environment where capital appreciation from falling interest rates or dramatically improving credit spreads is unlikely to continue, investors can seek to add return through yield and income and protect the downside by adopting a defensive interest rate posture. We illuminated three strategies for adding yield and income by utilizing a variety of instruments. Like any strategic theme or tactical shift, these trades will not last forever, but our intermediate term outlook suggests that patient investors can still look to their fixed income allocations to deliver the stability of results it is meant to provide.

Single family housing supply (4.6 months) is now well below the 30-year average of 7.1 months, according to the National Association of Realtors index of housing supply. While some observers note that "shadow inventory" is higher, this inventory is considered less desirable and usually no substitute for a well-maintained home and never for a new home. Affordability indices--taking into account housing prices and mortgage rates–remain near generational highs while the number of homeowners who are "underwater" continues to decrease. The improving employment picture should help as well.



Source: Bloomberg

For more information

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