Allegiance Capital

U.S. Fixed Income
Fourth Quarter, 2008

Macquarie Allegiance Capital's high quality (AAA) only portfolios produced one of their highest quarterly returns in more than fifteen years, and their largest outperformance to their Index targets in our history. Our risk averse, government focused investment approach performed well in an environment of serious credit losses, deflation, policy errors and the most severe recession in generations.

The quarter saw the continued credit crisis lead to all time lows on U.S. Treasury yields, producing significant capital gains in our portfolios. The U.S. Federal Reserve and Treasury's efforts to reduce private sector interest rates led to the Treasury announcing the Term Asset Backed Loan Facility to directly purchase up to $500b of Agency Mortgage Backed Securities (MBS) securities, Agency and Asset Backed Securities (ABS) securities. This step produced strong dollar price appreciation for these sectors which with our significant overweight further enhanced the capital gains in portfolios.

Our outperformance relative to our Index benchmarks resulted in part from our mandate of no credit exposure. Corporate bonds produced the worst yearly return in the sector's history. Credit losses, defaults and rising supply led to the sector producing a negative -4.94% as measured by the Barclays corporate Index.

Deflation will continue to be a primary concern into 2009 for policy makers as the economy experiences its largest contraction in aggregate demand since the Great Depression. The U.S. Federal Reserve's FOMC meeting in December highlighted the deflationary risks as they removed the Fed Funds target and further increased their balance sheet and non-monetary policy measures.

The U.S. Federal Reserve's FOMC statement was extraordinary in its clear language that they stand ready to use all available tools to stimulate economic growth. Their direct targeting of private sector interest rates and guarantees on many types of bank debt are encouraging as the traditional channels of monetary policy have failed to reduce private sector interest rates.

Economic indicators, both leading and trailing, are discouraging with the recent acceleration of the decline of home price of particular concern. The U.S. will almost certainly experience a deep and prolonged recession of a type not seen in generations as the excesses of the past years are slowly unwound. This deep, prolonged recession will keep interest rates low for an extended period, with the potential for Treasury rates to fall further.