



RICHMOND CAPITAL MANAGEMENT
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Second Quarter 2009

Interest Rate Trends

Quarterly Newsletter

While there are some green shoots in the economy that show life investors remain wary the economy will stumble as government stimulus fades. With the economy showing some signs of bottoming and the stock market rebounding, interest rates during the second quarter moved higher and the yield curve steepened even further. Even though the Federal Reserve is engaged in “quantitative easing” by purchasing U.S. Treasury debt, U.S. Agency debt and Agency Mortgage-Backed Securities, the market is anticipating the tremendous borrowing needs of the U.S. Treasury. In fact, the Treasury issued \$104 billion in debt securities alone the last week of the quarter. During the quarter,

Index Returns			
	Qtr.	1 Yr.	3 Yr. Ann.
Barclays Aggregate	1.78%	6.05%	6.43%
Barclays Govt/Credit	1.85%	5.26%	6.16%
Barclays Int. Govt/Credit	1.67%	5.27%	6.13%

Source: Barclays Capital

As of June 30, 2009

the two year note rose 31 basis points, the five year note rose 90 basis points, the ten year note rose 87 basis points and the thirty year bond rose 80 basis points. At the end of June, the yield differential between the two year note and the thirty year bond was 322 basis points, up from 273 basis points at the end of March.

Treasury Market Yields

	6/30/09	3/31/09
2 Year	1.11%	0.80%
5 Year	2.56%	1.66%
10 Year	3.53%	2.66%
30 Year	4.33%	3.53%

Commodities

Oil (\$ bal)	\$77.83	\$49.66
Gold (\$/oz.)	\$950.10	\$925.00
CRB Index	249.96	220.40

Spread Product (Spread to 10 Yr. Treasury)

10 Yr. “A” Corp	+2.72%	+3.76%
GNMA Current Coupon	+1.05%	+1.34%
10 Yr. “AA” Municipal	-0.08%	+0.72%

Economic Indicators

➤ On July 2nd, the June **Payroll Report** showed a loss of 467,000 non-farm payroll jobs. This reversed the trend in the first two months of the quarter where non-farm job loss had fallen from the March report of a 660,000 job loss. The unemployment rate edged closer to 10%, finishing the quarter at 9.5%. The silver lining in the employment front is that the rate of job loss is abating from the first quarter of this year and the unemployment increase in June was the smallest year to date.

➤ **Durable Goods** during the quarter showed surprising resiliency posting a strong rise of 1.8% in May, the same as April. Excluding transportation, orders rose 1.1% for the month of May. This rise in durable goods is the third rise in four months.

➤ The **Housing Market** continues to look for a bottom. The S&P/Case Shiller Index of 20 large cities showed a decline of 18.6% in prices year over year. This decline has stabilized since the first quarter and existing home sales actually rose 2.4% in May. This followed a rise in April and lifted sales to their highest rate all year.

➤ **Core Inflation** as measured by CPI excluding food and energy is relatively benign posting a small increase of .1% in May and up only 1.8% year over year.

Headline inflation continues to show a deflationary trend at -1.3% year over year due to the steep fall in oil from a year ago. The Federal Reserve noted in its latest report that “substantial resource slack is likely to dampen cost pressures....”

Federal Reserve

The FOMC left the fed funds rate unchanged at 0 - .25% at the June 24 meeting. Most importantly to the market, the Federal Reserve also left unchanged the amount of quantitative easing in place by keeping the intended purchases of U.S. Treasuries, Agencies and Mortgage-Backed Securities at the initial targets. While the Federal Reserve noted some stabilization of consumption and inventories they continue to remain attentive of the economy sliding further as the fiscal stimulus subsides.

As the U.S. economy shows some signs of stabilizing, the Federal Reserve has begun to discuss the process of removing the unprecedented monetary stimulus that has been employed to combat the financial crisis of 2008-9. This becomes particularly important as many economists point to the easy money during the Greenspan era for igniting the housing crisis which is at the center of the recent financial and economic meltdown. How and when to take off the various stimuli will be a crucial test for the Fed through the end of 2009 and the beginning of 2010 as they balance placing the economy on more stable footing with future inflation. Superimposed over this tricky stimulus removal are the tremendous debt needs of the U.S. Treasury with red ink as far as the eye can see. There is no wonder that interest rates in this environment continue to be incredibly volatile.

Unsexy

In the investment business, like the advertising business, sex sells. Private equity and alternative asset classes are “sexy,” promising high returns for relatively little risk. Investment grade bonds on the other hand are decidedly unsexy. Over the past ten years, some investors have allowed their bond holdings to dwindle as a percentage of their portfolios as they have increased allocations towards riskier asset classes. In many cases, the “sex appeal” of those alternatives led investors to put aside concerns about liquidity, transparency, and fees.

A recent Wall Street Journal article chronicling the performance of large endowments (assets greater than \$1 billion) points out that for the first time the large endowments will most likely lag behind their smaller counterparts. **The explanation: many alternative investments that were designed to provide uncorrelated returns to existing asset classes actually turned out to be highly correlated with those assets. When stocks went down in 2008, the alternatives went down with them. Making matters worse was the fact that the “sexy” asset classes lacked liquidity which created further issues.** According to the WSJ:

The so-called Yale approach espoused that endowments – as long-term investors unconcerned about redemptions or short-term market fluctuations – were the ideal candidates for alternatives. Yet in 2008, many of these assets became hard to sell, forcing schools to either dump their best-performing securities or funds, or borrow money, to meet their obligations.¹

Of course, the large endowments favoring the Yale model have drawn attention precisely because many of these institutions have been so famously successful over the past 20 years with their approach. But given the illiquidity of these institutions’ holdings in private equity and hedge funds, some speculate that the actual value of these kinds of assets has not yet been fully discounted to market levels. One thing that is sure, however, is that by design Yale model endowments own very few bonds. According to Barron’s², the average large endowment only invested 12% of their assets in bonds as of year-end 2008 -- this during a time when traditional bond investments (as represented by the Barclays Aggregate Index) have performed well.

	S&P 500 Total Return Index	Barclays Aggregate Index
(Through 6/30/2009)		
5 Year	-2.24%	5.01%
10 Year	-2.22%	5.98%
20 Year	7.74%	7.06%

Advocates of fixed income investing invariably bring up standard deviation statistics in a “bonds versus stocks” discussion. The “risk adjusted” returns of bonds make them an important component to a portfolio. Advocates of 100% stock portfolios have argued that with a long time horizon, only absolute return matters. **Ironically, at this point in time, the absolute return of bonds is quite competitive with that of stocks even over a period as long as the past 20 years. In other words, bonds have delivered solid total returns even setting aside the diversification benefits of the asset class.**

The financial press now makes frequent reference to our economy entering a post-financial crisis period called the “new normal”. The theory goes that the “new normal” period will feature lower growth and lower returns from financial assets for the foreseeable future. Such an environment would yield slim rewards for the kinds of risk-taking behavior that has characterized the past 10 years. **Given that scenario, many believe quality, liquidity, and diversity should be emphasized. But looking backwards in time, and importantly allowing for the big downward adjustment of the equity markets in 2008, is the new environment really any different than the past? It may be the case that “new normal” is no different from the “old normal.”**

¹ From WSJ “Ivy League Endowments Finally Dumb” 6/30/2009

² From Barron’s “The Big Squeeze” 6/29/2009