ATLANTA CAPITAL
INVESTMENT MANAGERS

FIXED INCOME MARKET REVIEW

December 31, 2011 (4Q) – **INVESTMENT COMMENTARY**

BOND MARKET REVIEW

US economic data showed improvement in the fourth quarter while the European debt crisis showed no signs of resolution. Treasuries posted modest returns following the previous quarter's rally but lagged other fixed income sectors. The Barclays Capital Aggregate Index returned 1.12% and the Merrill Lynch 1-3 Year Government Index returned 0.20%.

The European financial crisis continued to be at the forefront of investor concerns. Economic and banking sector fundamentals pose the greatest immediate threat. The fiscal austerity measures demanded by the stronger European countries are likely forcing the continent into recession. At the same time, banks and the heavily debt burdened countries that are relying on economic growth to provide much needed revenue increases have a significant amount of debt that will have to be refinanced in 2012. If investors shy away from the additional risks of refinancing the debt, interest rates will move higher putting even more pressure on budgets and balance sheets. In response to the European banks inability to borrow dollars, the Federal Reserve announced the creation of a temporary foreign currency swap arrangement coordinated with a number of foreign central banks. The action, which amounts to lending dollars to the ECB in exchange for euros as collateral, was put in place in December and likely prevented a liquidity event for at least one large European bank.

Despite the inability of Congress to agree to any longer term fiscal reform, the US economy appeared to be gaining momentum. Growth will likely top 3% in the fourth quarter resulting from broad based economic improvement (i.e., increased bank lending, consumer spending, manufacturing and the labor market.) Risk markets posted strong returns as equities rallied nearly 12% and lower quality debt outperformed. In the fourth quarter, 'BBB' rated bonds bested Treasuries by 1.57% while 'A', 'AA' and 'AAA' rated bonds outperformed by 0.65%, 0.19% and 0.10%, respectively. From a sector standpoint, corporate bonds and mortgage-backed securities led the market, outperforming Treasuries by 0.61% and 0.24%, respectively. Agencies roughly matched Treasuries in the quarter and the asset-backed sector lagged Treasuries by 0.28%, the likely result of European bank selling in an effort to raise dollars.

The Broad Market and Intermediate portfolios are positioned to benefit from "rolling down" the yield curve as they are overweight 7 to 10-year maturities. This area of the yield curve is very steep and as bonds of this maturity age, they get a price boost as their yields naturally decline. With negative real interest rates and positive economic growth, bond valuations are extended and overall portfolio durations remain shorter than the benchmark in all of the portfolios we manage. Mortgage rates are at record lows increasing the prepayment risk due to refinancing. To minimize this risk we are overweight mortgages that are backed by 15-year and 10-year loans, which are less attractive for homeowners to refinance, or by loans made prior to 2005. The older loans have already been through a refinance wave and provide more predictable cash flows than recently issued MBS backed by 30-year loans. In the short duration portfolios, we are focused on well structured CMOs and asset-backed securities (ABS) because they have low prepayment sensitivity to changes in interest rates. In the ABS sector we are maintaining full exposure to auto-loan backed ABS as their underlying credit fundamentals remain very strong and yields are favorable to Treasuries, agencies and many corporate credits. We continue to maintain a high quality bias as the coupon cushion for declining bond prices is greatly reduced.

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FOR FURTHER INFORMATION, CONTACT JIM SKESAVAGE (404) 682.2512 OR BRIAN SMITH, CFA (404) 682.2514.
1075 Peachtree Street NE, Suite 2100, ATLANTA, GA 30309