PNC Capital Markets

Repositioning Your Portfolio for Higher Rates...Eventually...

Investment Strategies in Uncertain Times

Independent Bankers Association of New York
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Saratoga Springs, NY

Presenter:
Robert DiPasquale – Senior Associate

My Presentation Today

Economic / Interest Rate Outlook

- What We Know/Fear
- Where Do We Go From Here
- How Do We Get There

Investment Performance Under Various Rate Scenarios

- Status Quo
- Bull Flattener
- Bear Steepener

Economic / Interest Rate Outlook

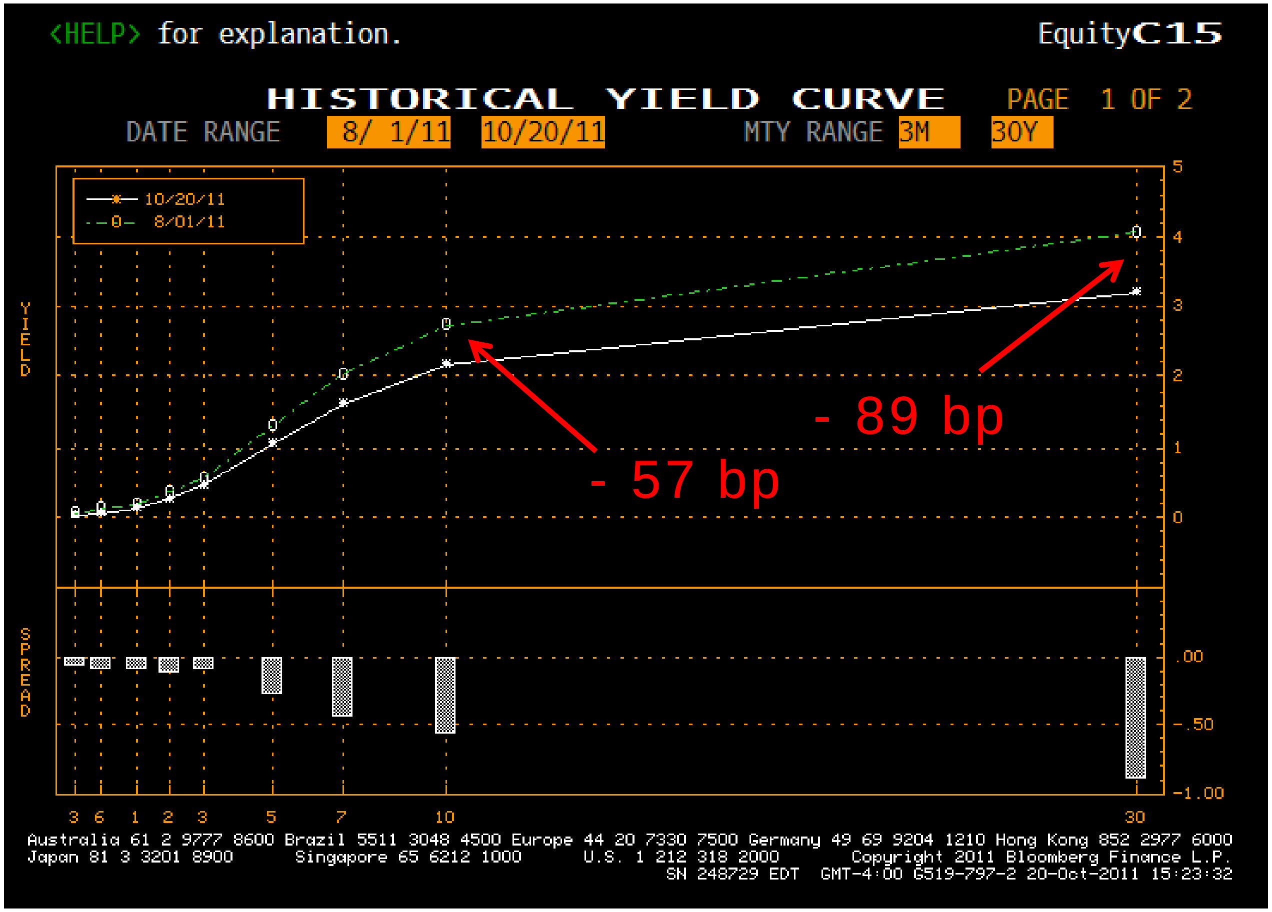
What We Know

It's been an awfully tough couple of years

Occupy Wall Street!!!

What We Know

Operation Twist hasn’t made managing a portfolio any easier



What We Know

Short Run Issues

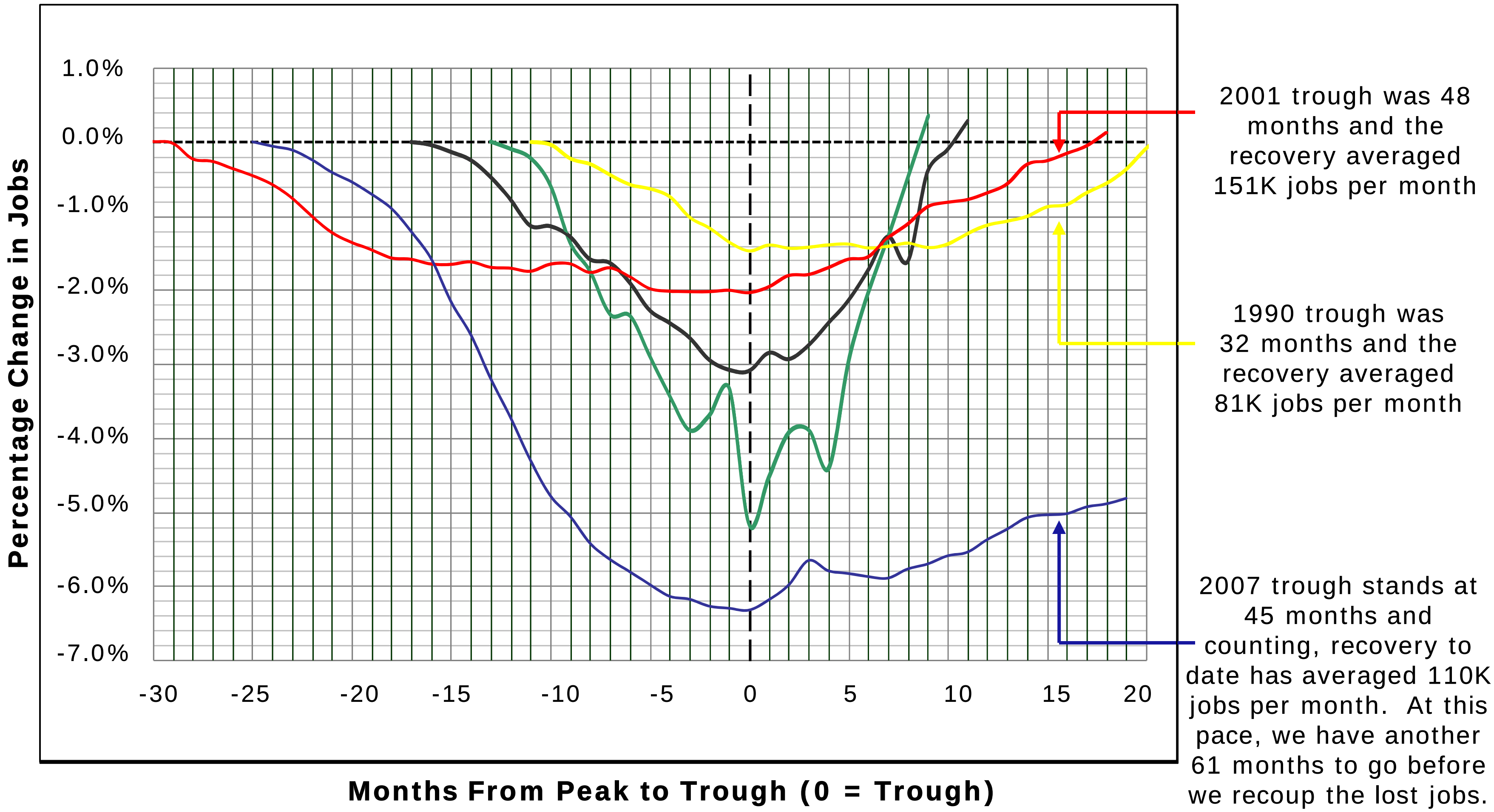
- Elevated unemployment, near zero wage growth and tepid loan demand
- Continued/eventual consumer, government and bank deleveraging
- The European debt crisis

Long Run or Structural Issues

- Uncertain regulatory environment (Dodd Frank, Basel II & III)
- Lack of a Congressional plan to meaningfully attack increasing government debt, deficits and the issues of entitlement spending
- Skill mismatch between workforce and hiring workplaces and a record high duration of unemployment

What We Know

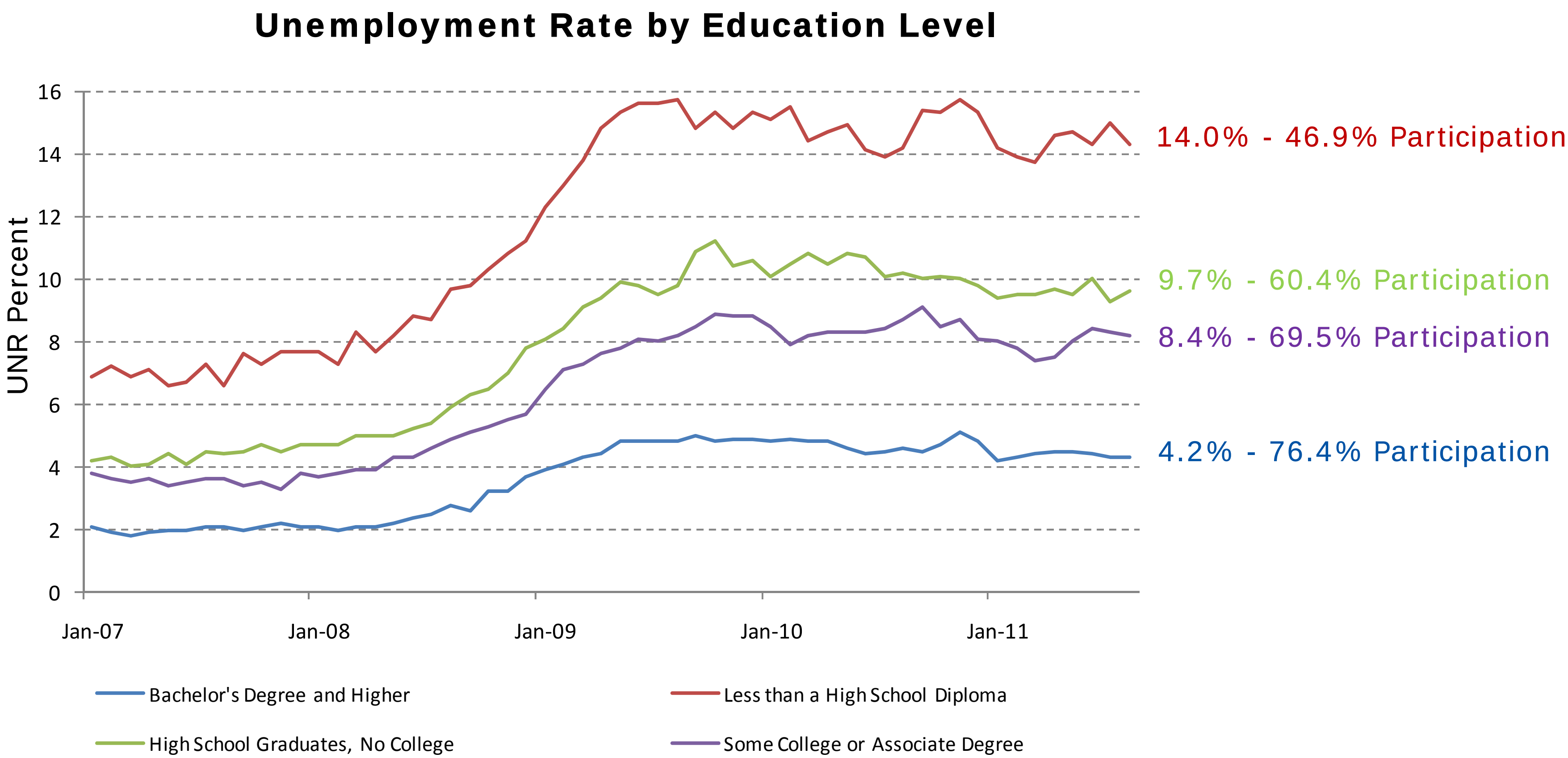
Unemployment will continue to weigh on the recovery for several more years



Source: Federal Reserve

What We Fear

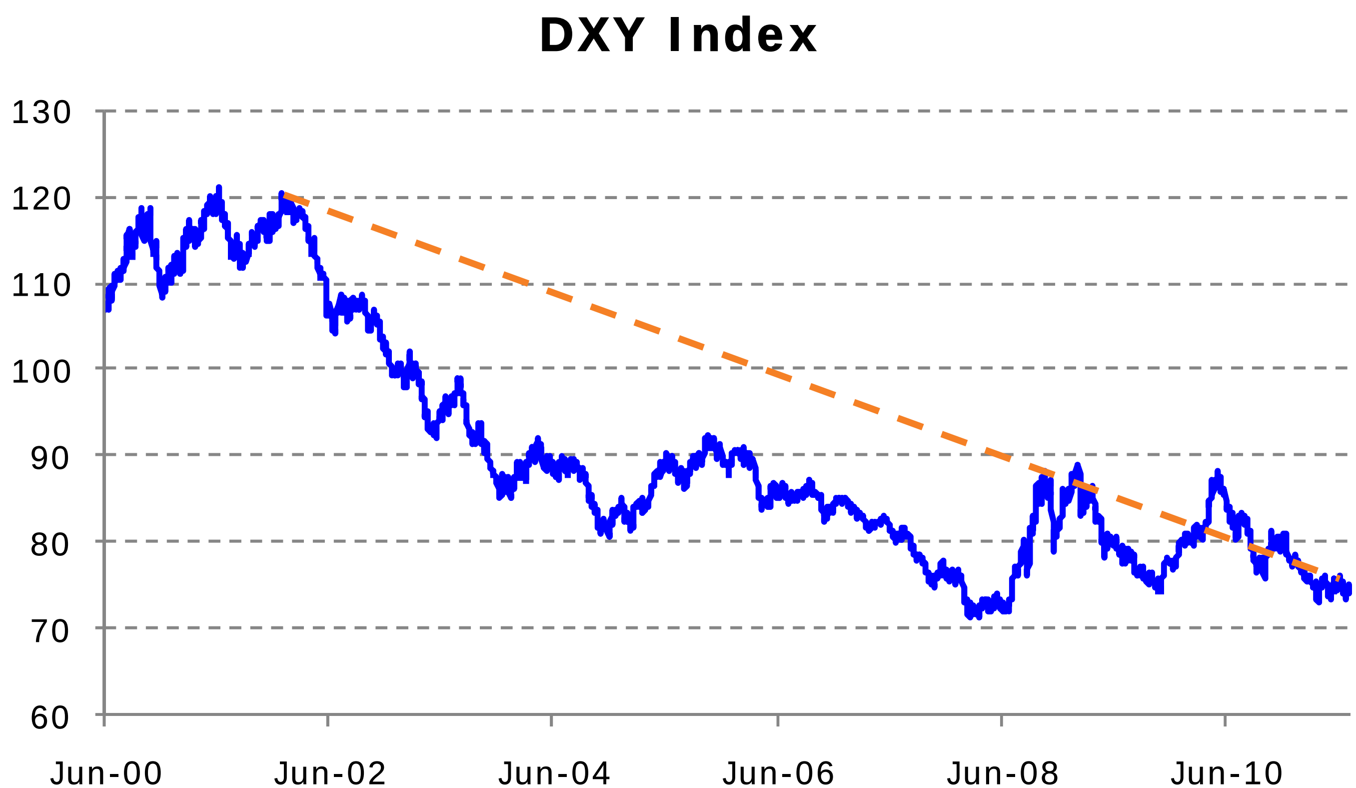
The Fed and government are targeting cyclical solutions for structural problems



Source: BLS

What We Fear

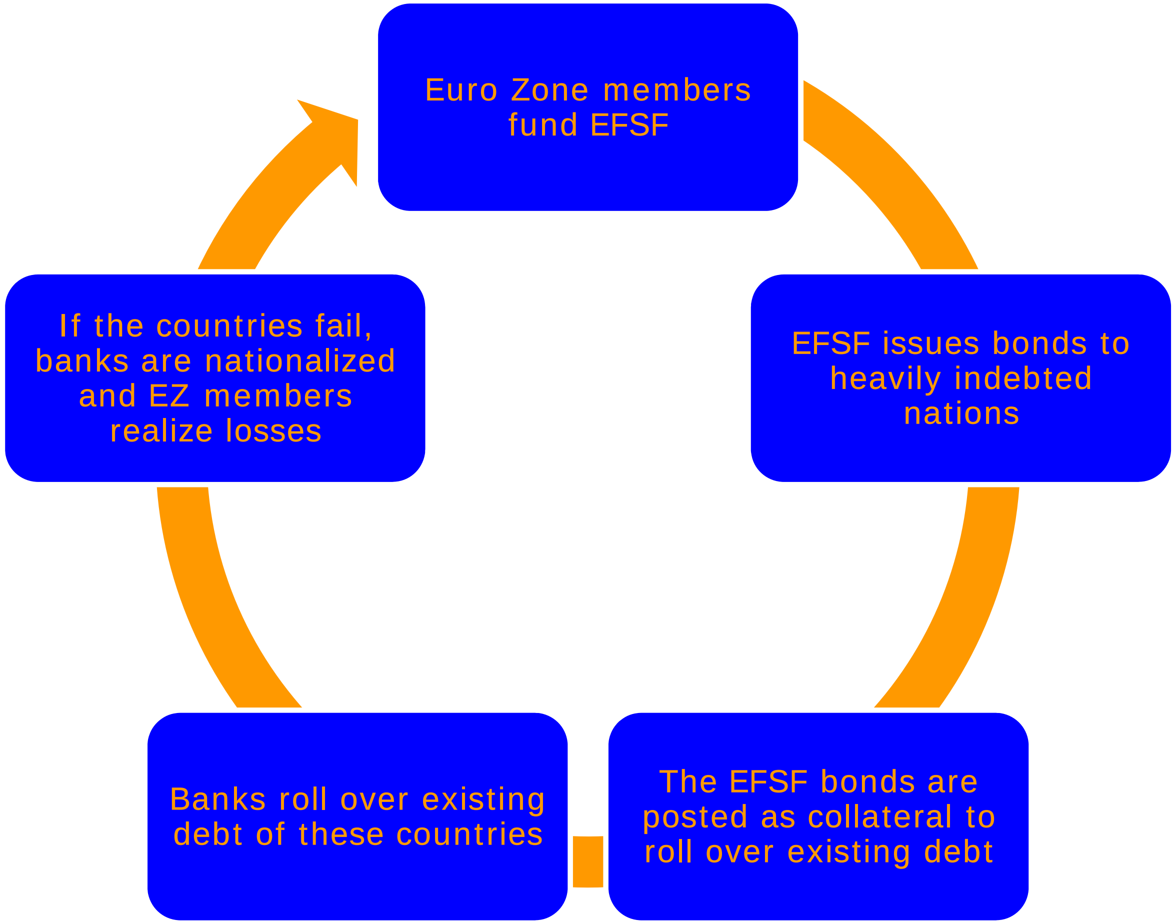
Since 2002, the dollar has lost almost 40% - we're becoming a price taker and no longer acting as a global price maker



Source: Federal Reserve

What We Fear

No solution in Europe



Where Do We Go From Here?

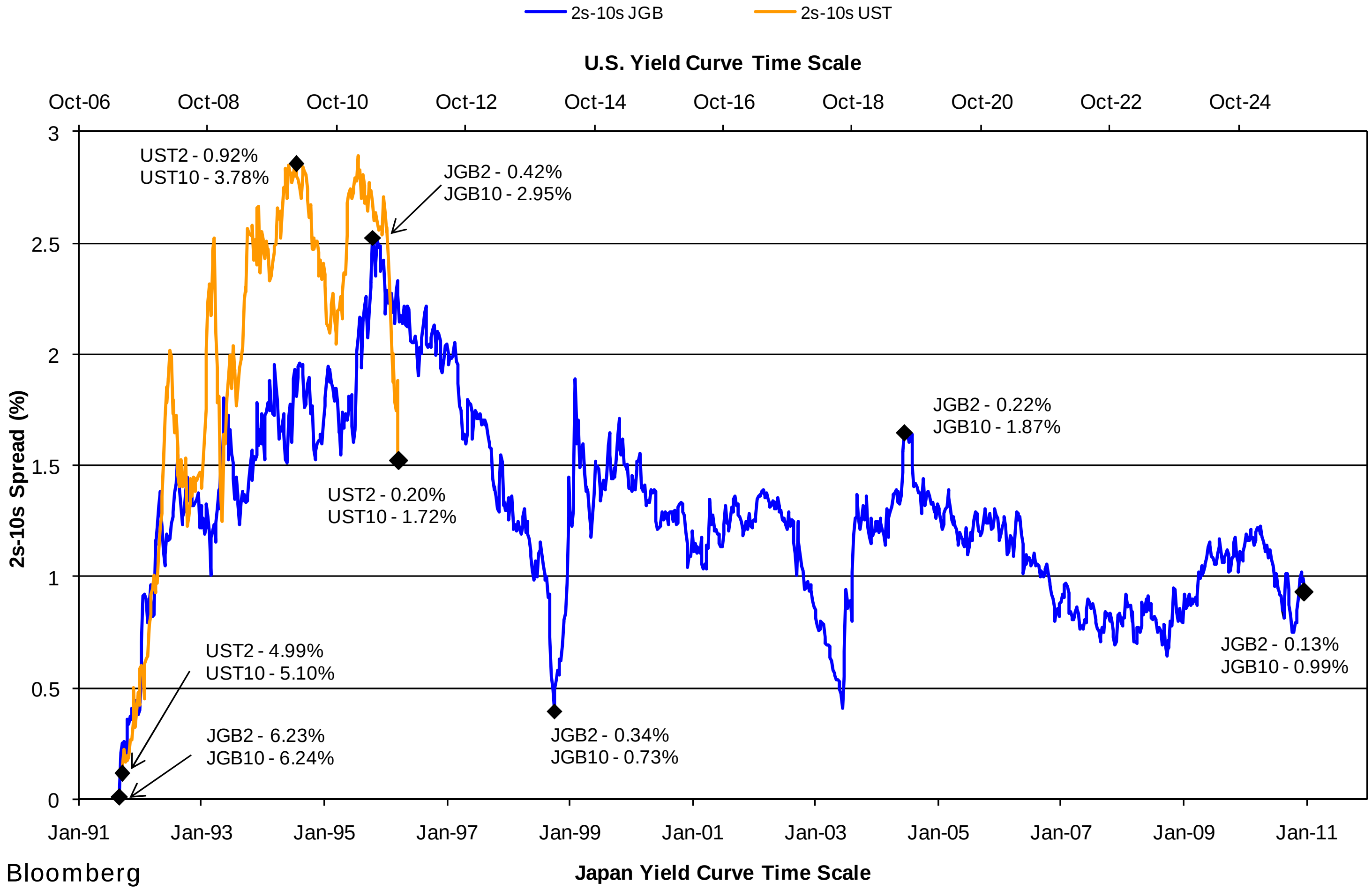
3 Potential Paths to Recovery from the Great Recession

- The **Fed's Fear** (Japan from 1990-2010)
  - The unemployment rate steadily rose from very low levels
  - GDP growth was well below trend
  - Yield curve flattened (short rates were steady, long rates fell)
  - Deflation or below target inflation (Bullard Paper)

Where Do We Go From Here?

Are we in for the same bull-flattening as Japan?

Japan vs U.S. - Yield Curve Graphs



Source: Bloomberg

Where Do We Go From Here?

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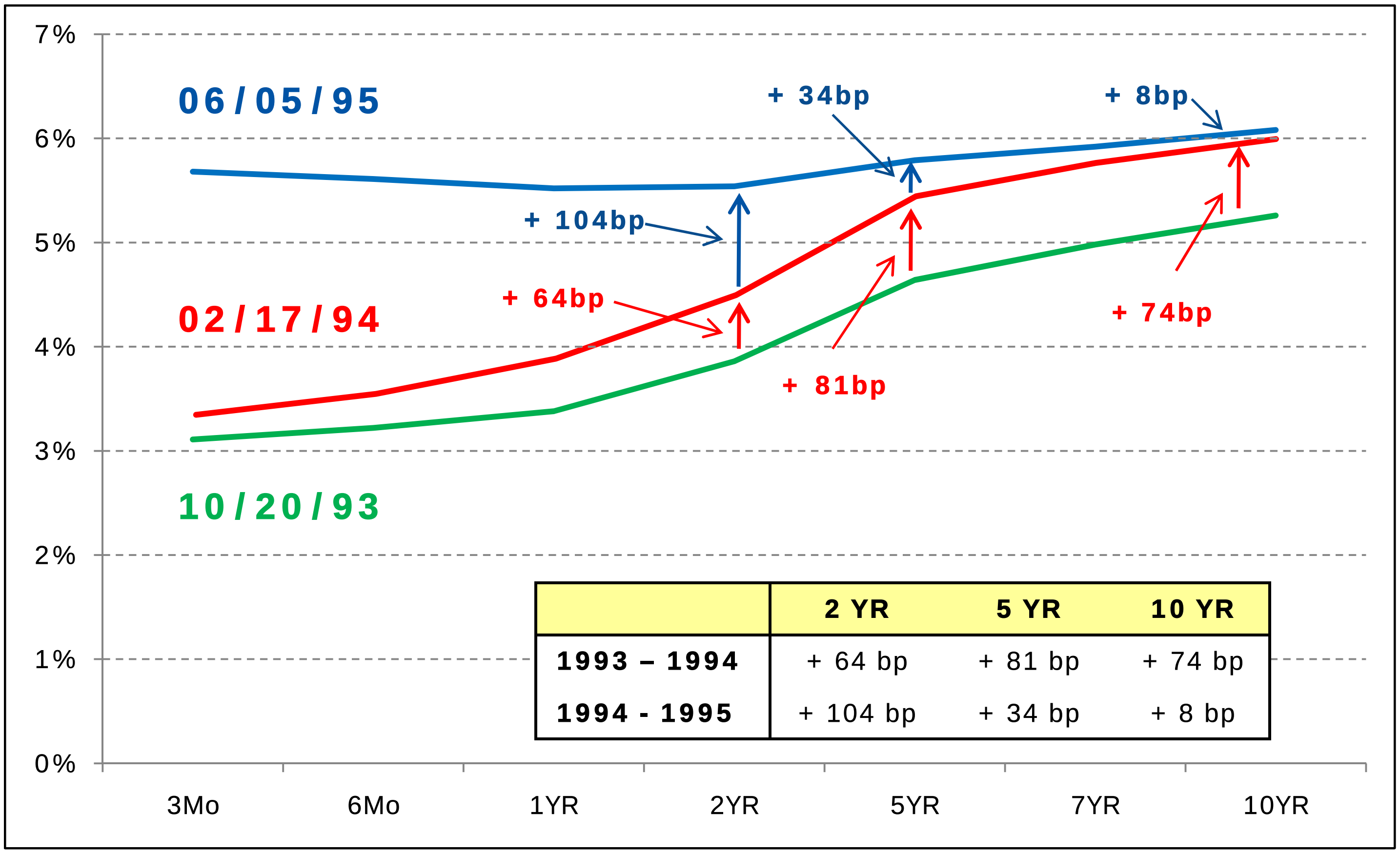
- The **Portfolio Manager's Fear** (1992-94 and 2003-05)
  - The unemployment rate slowly receded from the peak
  - GDP grew near trend
  - The yield curve flattened rapidly (short rates rose, long rates were steady)
  - Inflation held steady in target range

Where Do We Go From Here?

- Will the Fed be behind the curve again?
- Using the 1994 – 1995 tightening as an example



	2 YR	5 YR	10 YR
1993 – 1994	+ 64 bp	+ 81 bp	+ 74 bp
1994 - 1995	+ 104 bp	+ 34 bp	+ 8 bp

Where Do We Go From Here?

3 Potential Paths to Recovery from the Great Recession

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- The **Half Speed Recovery** (Somewhere in-between)
  - Unemployment takes many years to recover to pre-recessionary levels
  - GDP grows below its long-run 3% trend
  - Yield curve bull flattens as the Fed maintains a zero interest rate policy
  - Inflation expectations remained reasonably well anchored

How Do We Get There?

How many bullets does the Fed have left?

- Bernanke remains committed to taking further action as appropriate, although monetary policy is not a "panacea" for the U.S. economy
- Additional Options the Fed may look to:
  - New round of asset purchases (QE3)
  - Reduce the interest paid on excess reserves
  - Inflation targeting, i.e. letting inflation increase in the short run
- We have to ask, at the margin, how much effect would these measures really have on the recovery?

How Do We Get There?

- The definition of "extended period"… ***LIKELY***, at least through mid 2013
  - "However, the Committee will continue to pay close attention to the evolution of inflation and inflation expectations."
  - If inflation expectations move higher the Fed may have to decide which side of their dual mandate they'll target, inflation or unemployment
- Short-term rates will remain anchored at least through mid 2013
  - With operation twist the curve is likely to stay flat, especially 10s – 30s
  - Investment portfolios should consider adding duration and selling convexity to take advantage of the Fed's zero interest rate policy
- Long-term rates, specifically the 10-yr part of the curve, are likely to remain below 2.50% until we see signs this recovery is truly self-sustaining

Investment Performance Under Various Rate Scenarios

Securities We'll Focus On

- **15 Year FNMA MBS**
  - 3.50% 15 year mortgage pass-through security
- **30 Year FNMA MBS**
  - 4.00% 30 year mortgage pass-through security
- **5/1 GN Hybrid ARM**
  - 3.50% initial coupon then 1 Year UST + 150 bp with 1/1/5 caps
- **CMO Floater**
  - Floating rate security paying 1ML + 50 bp, off 30 year FNMA collateral
- **Agency 5 year Bullet**
  - 1.375% 5 year FNMA bullet security
- **BQ Municipal**
  - 3.7% 10 year bank qualified GO bond

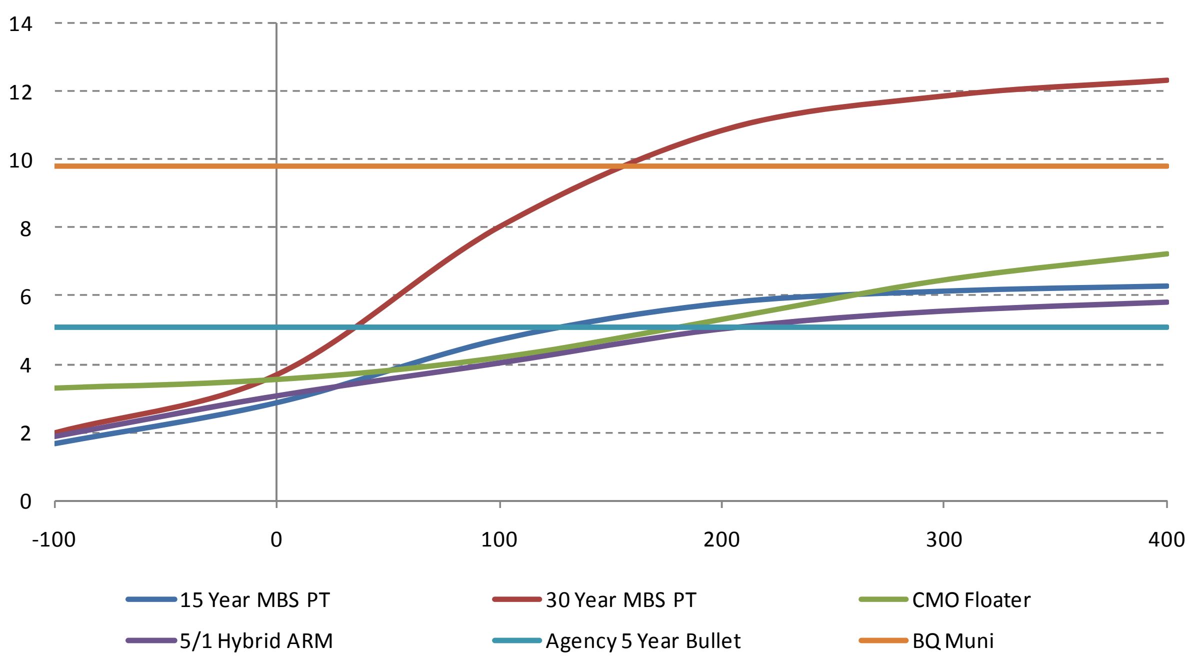
Base Case Analytics

	Base Case Analytics					
Description	Price	Yield	WAL	Eff. Duration	Eff. Convextity	OAS
15 Year MBS PT	103.41	2.17%	2.87	2.28	-2.04	25
30 Year MBS PT	103.31	2.94%	3.70	3.68	-2.54	27
CMO Floater	100.26	0.67%	3.55	0.73	0.80	28
5/1 Hybrid ARM	105.27	1.30%	3.08	1.27	-1.77	21
Agency 5 Year Bullet	99.59	1.46%	5.07	4.88	0.27	4
BQ Muni	107.27	2.84%	9.81	4.94	-0.62	-26

Source: BlackRock Analytics

Base Case Extension Risk – WAL

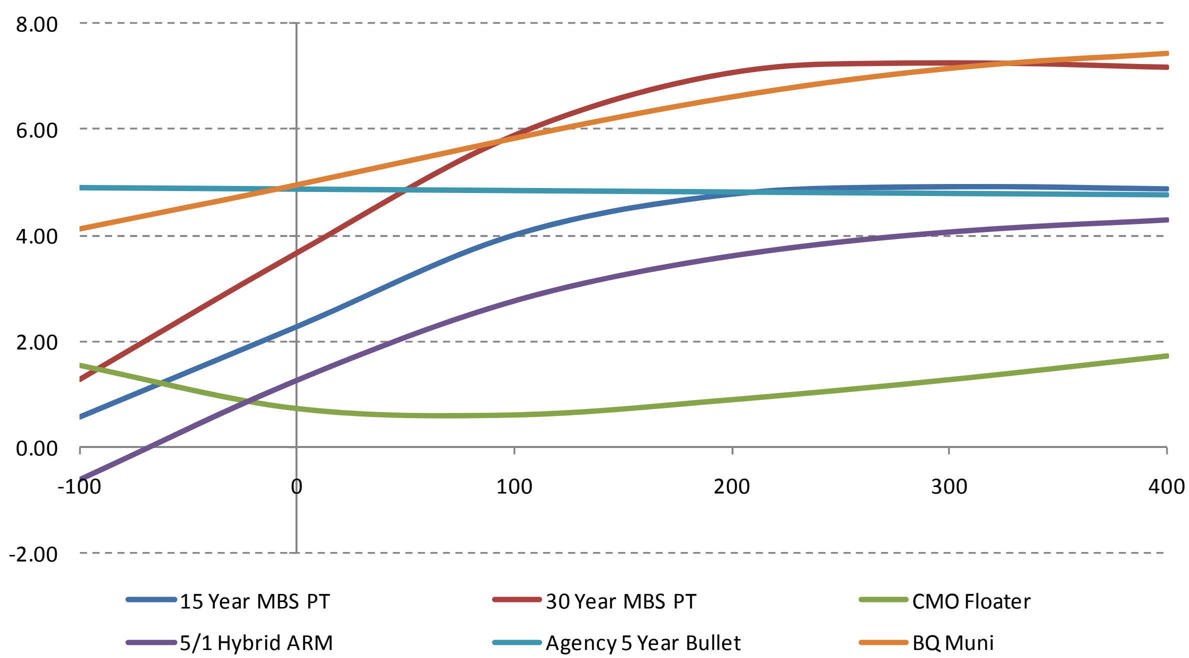
	Weighted Average Life					
Description	**-100**	**0**	**100**	**200**	**300**	**400**
15 Year MBS PT	1.66	2.87	4.73	5.80	6.16	6.31
30 Year MBS PT	1.99	3.70	8.03	10.85	11.86	12.32
CMO Floater	3.30	3.55	4.19	5.31	6.46	7.22
5/1 Hybrid ARM	1.89	3.08	4.04	5.04	5.56	5.82
Agency 5 Year Bullet	5.07	5.07	5.07	5.07	5.07	5.07
BQ Muni	9.81	9.81	9.81	9.81	9.81	9.81



Source: BlackRock Analytics

Base Case Extension Risk – Duration

	Effective Duration					
Description	**-100**	**0**	**100**	**200**	**300**	**400**
15 Year MBS PT	0.57	2.28	4.01	4.78	4.92	4.88
30 Year MBS PT	1.29	3.68	5.90	7.08	7.26	7.18
CMO Floater	1.55	0.73	0.61	0.90	1.28	1.73
5/1 Hybrid ARM	-0.61	1.27	2.77	3.62	4.07	4.30
Agency 5 Year Bullet	4.91	4.88	4.85	4.82	4.79	4.76
BQ Muni	4.11	4.94	5.82	6.60	7.14	7.42



Source: BlackRock Analytics

Horizon Rate of Return Analysis

- The yield curve rarely experiences a pure parallel shift
- To add a measure of realness we twisted the yield curve over the next 24 months and looked at the horizon rate of return for these bonds
- The horizon rate of return looks at the projected market value of the bond at the end of the period as well as interest received during that period
- We selected a 24 month period to coincide with the Fed's pledge to keep rates exceptionally low through at least mid 2013
- Using BlackRock's analytics package, the scenarios we examined are:
  - ➢ Yield curve moves sideways for the next two years
  - ➢ Yield curve bull flattens over the next two years
  - ➢ Yield curve bear steepens over the next two years

With the Fed on Hold, Three Likely Scenarios

Status Quo

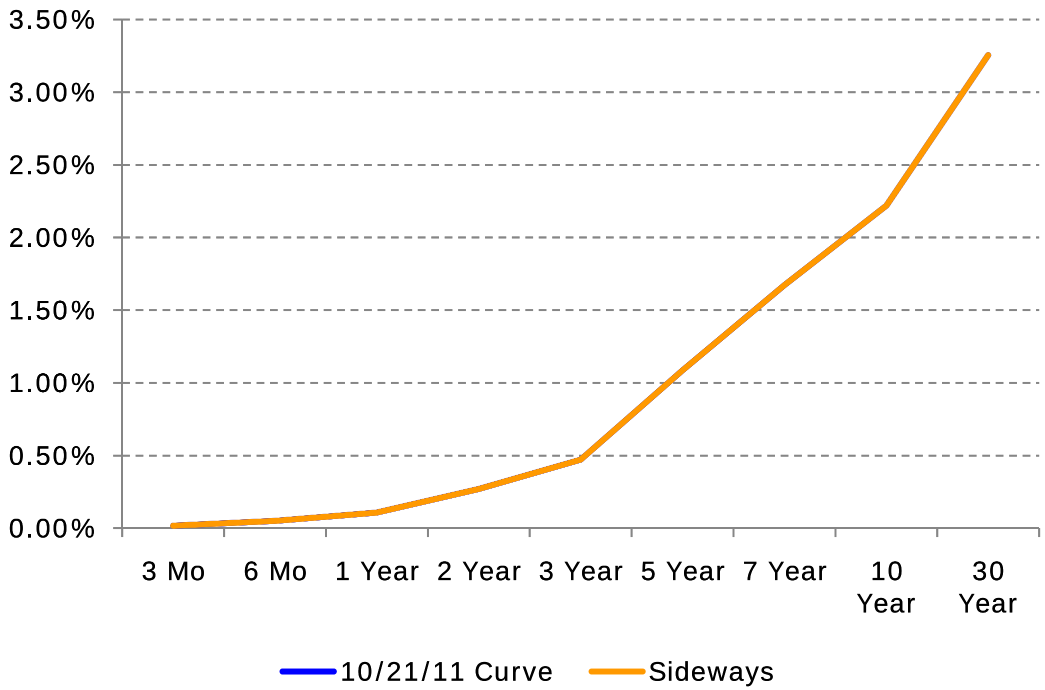
- No dramatic change in the economy and the yield curve moves sideways for two years as the Fed maintains its zero interest rate program
- 2’s stay at 15bp – 25bp and 10’s stay in a range of 175bp – 225bp

Status Quo Scenario

Yield curve stays as is for the next two years

Shift	**0 - 2YR**	**3 year**	**5 year**	**7 year**	**10 year**	**15 year**	**20 year**	**25 year**	**30 year**
Sideways	0 bp	0 bp	0 bp	0 bp	0 bp	0 bp	0 bp	0 bp	0 bp

Yield Curve	**3 Mo**	**6 Mo**	**1 Year**	**2 Year**	**3 Year**	**5 Year**	**7 Year**	**10 Year**	**30 Year**
10/21/11 Curve	0.02%	0.05%	0.11%	0.27%	0.47%	1.09%	1.67%	2.22%	3.26%
Sideways	0.02%	0.05%	0.11%	0.27%	0.47%	1.09%	1.67%	2.22%	3.26%



With the Fed on Hold, Three Likely Scenarios

Status Quo

- No dramatic change in the economy and the yield curve moves sideways for two years as the Fed maintains its zero interest rate program
- 2’s stay at 15bp – 25bp and 10’s stay in a range of 175bp – 225bp

Bull Flattener

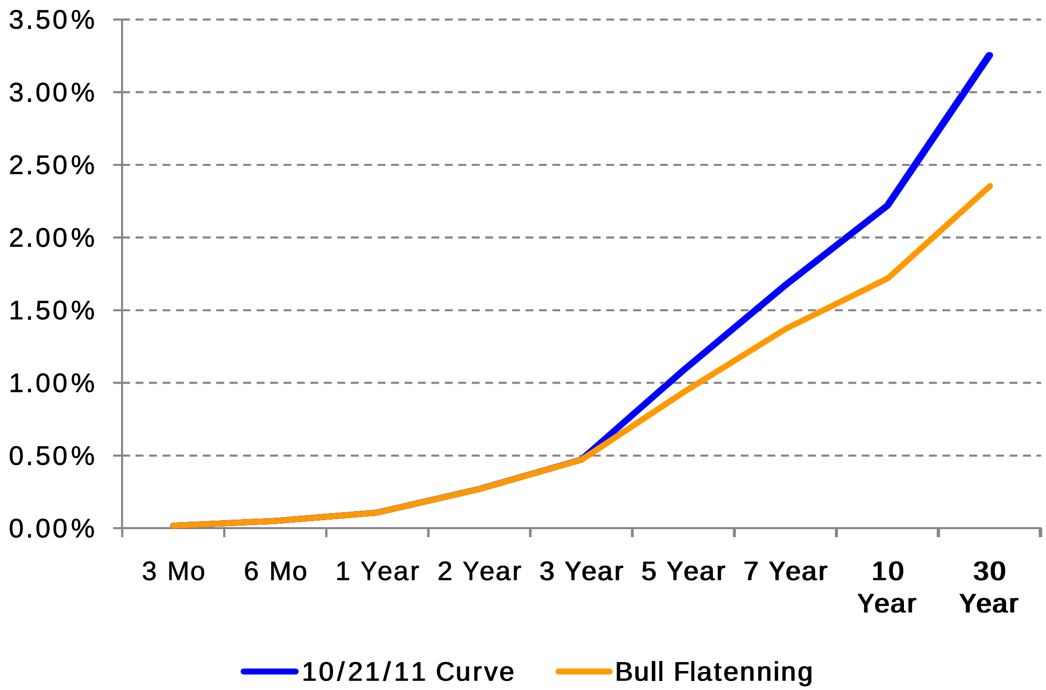
- Economic growth continues to slow down and the long end of the curve rallies over the next two years as the Fed adds accommodation
- 2’s stay at 15bp – 25bp and 10’s rally towards 125bp

Bull Flattener Scenario

Yield curve bull flattens over the next two years

Shift	**0 - 2YR**	**3 year**	**5 year**	**7 year**	**10 year**	**15 year**	**20 year**	**25 year**	**30 year**
Bull Flattening	0 bp	0 bp	- 15 bp	- 25 bp	- 50 bp	- 60 bp	- 70 bp	- 80 bp	- 90 bp

Yield Curve	**3 Mo**	**6 Mo**	**1 Year**	**2 Year**	**3 Year**	**5 Year**	**7 Year**	**10 Year**	**30 Year**
10/21/11 Curve	0.02%	0.05%	0.11%	0.27%	0.47%	1.09%	1.67%	2.22%	3.26%
Bull Flatenning	0.02%	0.05%	0.11%	0.27%	0.47%	0.94%	1.37%	1.72%	2.36%



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With the Fed on Hold, Three Likely Scenarios

Status Quo

- No dramatic change in the economy and the yield curve moves sideways for two years as the Fed maintains its zero interest rate program
- 2's stay at 15bp – 25bp and 10's stay in a range of 175bp – 225bp

Bull Flattener

- Economic growth remains at half speed or slows further and the long end of the curve rallies over the next two years as the Fed adds accommodation
- 2's stay at 15bp – 25bp and 10's rally towards 100bp

Bear Steepener

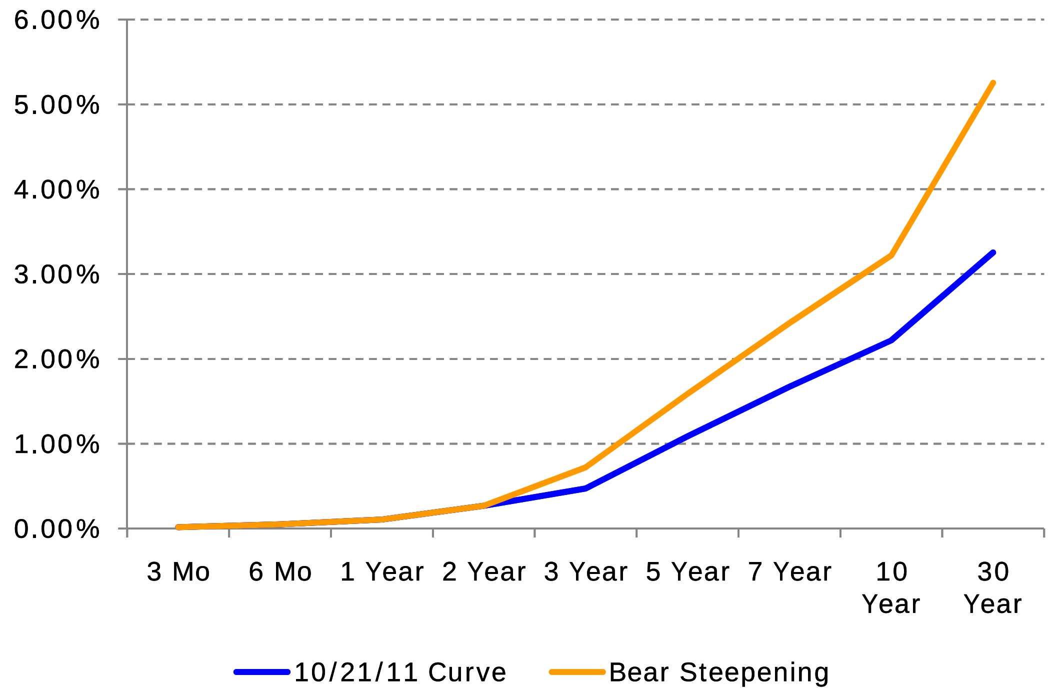
- The ZIRP causes inflation to take off and/or the economic recovery takes hold and the market pushes the long end of the curve higher in response
- 2's stay at 15bp – 25bp and 10's back up towards 300bp

Bear Steepener Scenario

Yield curve steepens over the next two years

Shift	0 - 2YR	3 year	5 year	7 year	10 year	15 year	20 year	25 year	30 year
Bear Steepening	0 bp	+ 25bp	+ 50 bp	+ 75 bp	+ 100 bp	+ 125 bp	+ 150 bp	+ 175 bp	+ 200 bp

Yield Curve	3 Mo	6 Mo	1 Year	2 Year	3 Year	5 Year	7 Year	10 Year	30 Year
10/21/11 Curve	0.02%	0.05%	0.11%	0.27%	0.47%	1.09%	1.67%	2.22%	3.26%
Bear Steepening	0.02%	0.05%	0.11%	0.27%	0.72%	1.59%	2.42%	3.22%	5.26%



Status Quo Results

Yield curve moves sideways for the next two years

Security	Price	Yield	Duration	HROR	Price	ΔPrice
15 YR PT	103.41	2.17%	2.28	1.87%	103.90	0.49
30 YR PT	103.31	2.94%	3.68	2.61%	103.62	0.30
CMO Floater	100.26	0.67%	0.73	0.71%	100.42	0.16
5/1 ARM	105.27	1.30%	1.27	1.36%	104.69	-0.58
5 YR AGY	99.59	1.46%	4.88	2.32%	101.54	1.94
BQ Muni	107.27	2.84%	4.94	1.91%	104.06	-3.21

Source: BlackRock Analytics

Bull Flattener Results

Yield curve flattens over the next two years

Security	Price	Yield	Duration	HROR	Price	ΔPrice
15 YR PT	103.41	2.17%	2.28	1.94%	104.19	0.78
30 YR PT	103.31	2.94%	3.68	2.91%	104.68	1.36
CMO Floater	100.26	0.67%	0.73	0.76%	100.60	0.34
5/1 ARM	105.27	1.30%	1.27	1.28%	104.38	-0.89
5 YR AGY	99.59	1.46%	4.88	2.33%	101.55	1.96
BQ Muni	107.27	2.84%	4.94	1.99%	104.25	-3.02

Source: BlackRock Analytics

Bear Steepener Results

Yield curve steepens over the next two years

Security	Price	Yield	Duration	HROR	Price	ΔPrice
15 YR PT	103.41	2.17%	2.28	0.90%	99.27	-4.14
30 YR PT	103.31	2.94%	3.68	0.16%	95.60	-7.71
CMO Floater	100.26	0.67%	0.73	0.65%	99.62	-0.64
5/1 ARM	105.27	1.30%	1.27	1.13%	103.04	-2.23
5 YR AGY	99.59	1.46%	4.88	0.30%	97.43	-2.16
BQ Muni	107.27	2.84%	4.94	0.04%	99.95	-7.32

Source: BlackRock Analytics

All Scenarios Comparison

	24 Month HROR			24 Month Projected Price		
Security	Status Quo	Bear Steepening	Bull Flattening	Status Quo	Bear Steepening	Bull Flattening
15 YR PT	1.87%	0.90%	1.94%	103.90	99.27	104.19
30 YR PT	2.61%	0.16%	2.91%	103.62	95.60	104.68
CMO Floater	0.71%	0.65%	0.76%	100.42	99.62	100.60
5/1 ARM	1.36%	1.13%	1.28%	104.69	103.04	104.38
5 YR AGY	2.32%	0.30%	2.33%	101.54	97.43	101.55
BQ Muni	1.91%	0.04%	1.99%	104.06	99.95	104.25

Source: BlackRock Analytics

Conclusions

- We don't believe that this is a repeat of 2008 as banks and corporations are in much stronger capital positions.
- The Fed told us they are on hold through at least mid 2013, take advantage of what steepness you can in the yield curve.
- If the next Fed move is to cut the IOER rate from 25bp, short duration bonds are going to become more expensive as banks crowd into them as an alternative
- If you think rates will be here or lower over the next two years, consider adding as much duration as you are comfortable holding
- If you think rates will be higher, or you already have a long duration portfolio, consider adding short or floating rate bonds as insurance

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