

Fixed Income Outlook

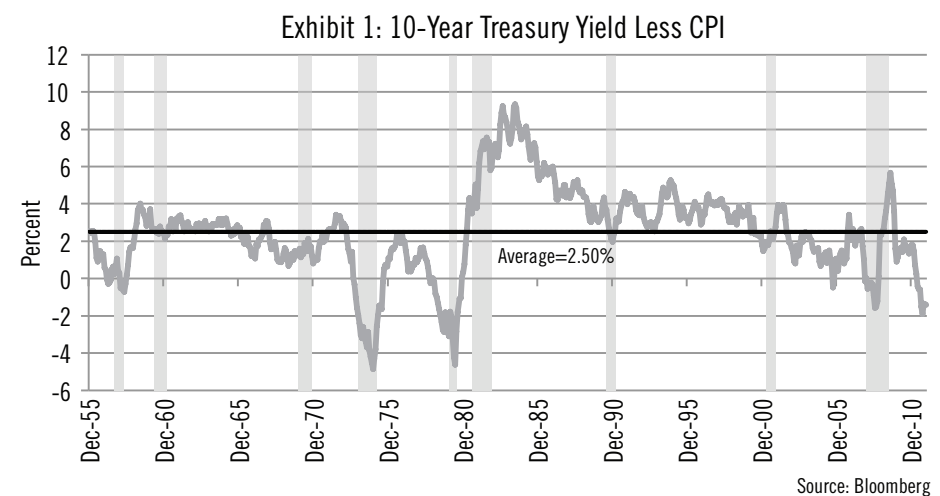
COMMENTARY AND INVESTMENT STRATEGY

January 2012

The “Great Recession” officially ended in 2009, but one wouldn’t know it judging by the level of interest rates in the United States. The Federal Funds rate of zero, U.S. 10-year Treasury yields of about 2% and the long bond yield of 3% are all near record lows. The Federal Reserve’s aggressive use of monetary policy and fears of a European banking crisis have kept rates at rock bottom levels.

Europe is a major wildcard in the outlook for the economy and interest rates. While the risks of recession in Europe are growing, the U.S. economy clearly gained strength in the second half of 2011. Hopeful signs of an improving labor market are finally emerging. In December, the number of Americans filing claims for unemployment benefits dropped to the lowest number in three years. Net job growth has been positive for fourteen consecutive months, and the unemployment rate, at 8.5%, is well below the peak level of 10.1% reached in 2009. Will problems in Europe derail the economic recovery in the United States? We believe the answer is no, but the downside risks to growth from Europe are clearly present. We also believe the downside risks are fully discounted in the price of U.S. Treasury bonds.

Over time, investors in intermedi-



ate maturity U.S. government bonds have earned a return of about 2% more than inflation. The latest reported year over year change in the consumer price index was 3.4%. In order to receive a 2% premium over inflation, the 10-year Treasury would need to yield close to 5.5%, over twice the present yield of 2%. Of course, determining fair value and the appropriate level for yields should depend on future, rather than past, inflation trends. If we assume the trend rate of inflation falls toward the Federal Reserve’s informal target of 2%, implied fair value for the 10-Year Treasury is about 4%. Why is the present yield of 2% so far below what is implied by this model? The simple answer is supply and demand. U.S. Treasury bonds are perceived to be the world’s

safest financial asset. During this time of heightened uncertainty surrounding Europe’s sovereign debt and the health of their major banks, strong demand for U.S. Treasury bonds has kept yields at exceptionally low levels. As the crisis atmosphere in the global financial markets improves, we anticipate demand for Treasury bonds to diminish without any offset in supply. We expect this shift in supply and demand will put upward pressure on long term yields set by market forces. The timing of this change is difficult to predict, but the outcome is highly likely.

To manage risk and capitalize on market opportunities our strategy is emphasizing three themes. First, we believe it is prudent to maintain a defensive maturity structure to mini-

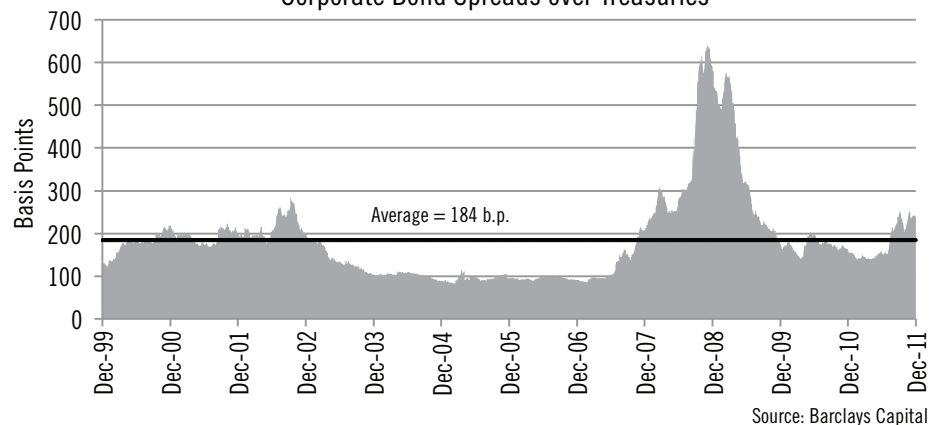
mize interest rate risk. We recommend holding a minimal exposure to securities with a maturity longer than ten years. Second, our analysis suggests corporate bonds offer better relative value than government securities, and we recommend an overweight to the corporate sector. Finally, we believe the market is underestimating the risk of inflation over the intermediate term. As a hedge against inflation, our core strategy holds Treasury Inflation Protected Securities (TIPS).

Investment Grade Corporates

Investment grade corporate bonds experienced total returns of 8.15% in 2011, led by utilities. However, spreads widened during the year relative to Treasury bonds. The Barclays Corporate Investment Grade Index OAS (option adjusted spread) ended 2011 at 234 basis points (b.p.), 78 b.p. wider than the close of 2010. This reflects the fact that Treasury yields declined more than comparable corporate bonds at various maturities.

After outperforming in 2010 and the first quarter of 2011, financials underperformed industrials and utilities over the remaining nine months of the year. This was due to the worsening Eurozone crisis, increased regulation and counterparty concerns. Banks were the worst performing area of the financials sector in 2011, garnering a total return of 1.56%. With the significant underperformance from financials, the financial/industrial OAS ratio is approaching all-time highs reached in

Exhibit 2: Barclays Capital U.S. Investment Grade Corporate Bond Spreads over Treasuries



2008 and early 2009 in the midst of the financial crisis.

Longer term utilities achieved the highest total returns in 2011, soaring 21.3%. This outpaced longer term industrial bonds, which generated an average return of 18.0%. Financials lagged the other two sectors with long-term securities gaining 5.6%.

Investment grade companies' operating fundamentals are strong by historical standards and earnings expectations for 2012 appear to be fairly good. After peaking during the 2007-2009 recession, corporations' net leverage declined rapidly and has returned to pre-recession levels. Debt issuance in 2011 amounted to \$858 billion, down from \$901 billion in 2010. Forecasts for 2012 project continued strong demand in investment grade debt along with lower debt issuance as compared to 2011, especially in the financials. This scenario would be conducive to narrower spreads during the year.

As we enter 2012, the Barclays Corporate Investment Grade Index is at the second widest spread level to begin

a year since 1990. The start of 2009 saw the widest spread as investors assessed the extent of the financial crisis. It is interesting to note that spreads narrowed materially in 2009. We believe corporate bonds are attractive at these spreads as individuals analyze the duration of the current Eurozone problems. If individuals see any progress in Europe during the year, there is considerable potential for spreads to narrow, notably in the financials.

We believe the weakness in financials makes this sector relatively attractive in 2012, although there will be volatility in light of the ongoing European situation. The banks' capital levels and asset quality are much stronger than in 2008. Also, regulators have stringent capital requirements that should be beneficial to bondholders.

Residential Mortgage-Backed Securities

After four years of one of the deepest declines in history, the U. S.

housing market essentially “marched in place” during 2011. By most measures, housing appears to be bumping along a bottom. New home sales, existing home sales and pending home sales reached their lows during the first half of the year and have moderately recovered in the second half. Available inventory for sale has also declined to 7 months for existing homes and 6 months for new homes, the latter a level not seen since March 2006. Home prices declined during the year although at a slower pace than the previous three years. The FHFA and S&P/Case-Shiller home price indices declined 2.8% and 3.9% respectively.

The big negatives for housing remain the slow growth in employment and the large overhang of potential inventory of foreclosed homes. Employment growth remains subpar for this stage of the economic recovery but has recently shown signs of strength. Payroll growth has averaged 145,000 monthly since August and the unemployment rate has fallen to 8.5%. Po-

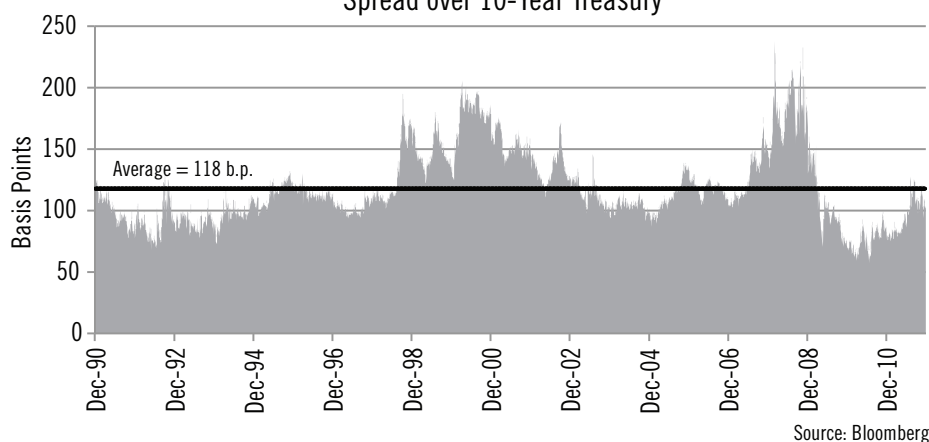
tential foreclosures remain a problem. The failure of states’ attorneys general and mortgage servicers to reach an agreement on foreclosure procedures have produced a backlog of home foreclosures, leaving prospective buyers leery of further declines in home prices. Despite these negatives, the housing sector has strong fundamentals in place which should eventually lead to a moderate recovery. A combination of low interest rates, median household income growth and lower home prices has raised home affordability, as measured by the National Association of Realtors, to historically high levels. In addition, household formation remains well above the level of new home constructions, potentially providing a boost to demand for new home construction.

Aside from the fundamentals listed above, investors and consumers must contend with the uncertainty of further government intervention in the mortgage market aimed at providing relief to current home owners and further stimulation of the economy.

Federal programs such as HARP (Home Affordability Refinance Program), which encourages banks to write-down portions of principal in existing agency-backed mortgages and the potential for additional buying of mortgages by the Federal Reserve Board have narrowed mortgage-backed security spreads and increased prepayment risk for investors. As a result, we remain underweight the mortgage sector, given historically tight spreads and the considerable prepayment and convexity risks associated with low mortgage rates. We continue to prefer older, higher coupon mortgages, which we believe offer relative value in terms of prepayment protection, as a large number of these borrowers are credit constrained from refinancing.

Non-agency RMBS has been under significant pressure since April, when the Federal Reserve announced it would auction off the portfolio of non-agency assets it acquired from AIG during the financial crisis. We continue to avoid purchases in this sector given the difficult and highly sensitive assumptions required to value these securities appropriately.

Exhibit 3: Fannie Mae 30-Year Current Coupon Spread over 10-Year Treasury



Source: Bloomberg

Commercial Mortgage-Backed Securities (CMBS)/Asset Backed Securities (ABS)

Despite a stronger showing in the fourth quarter, CMBS underperformed other sectors of the fixed income market for the year. Spreads for this high beta sector widened as risk aversion

took hold mid-year, reflecting market concerns about weak global growth and credit risk in European sovereigns and their closely related banking institutions. These concerns raised the specter of forced asset sales by failing European banks and those that might be pressured to deleverage. New issuance slowed dramatically during the middle of the year before picking up again in the fourth quarter. However, it remains significantly below the levels seen during the height of the housing bubble in 2007.

Commercial property performance continues to stabilize as the broader

economy improves, but the dispersion between top-tier and lower classed properties and markets remains.

Property prices for so-called trophy assets have improved off their lows, although this improvement is being offset by distressed transactions that continue to place downward pressure on the broader market. Concerns also remain about the ability of CMBS borrowers to refinance maturing loans on properties that are now significantly below their original value. Most CMBS loans are structured to balloon after five or ten years, and if they cannot be refinanced, properties can be liqui-

dated significantly below their book value. We remain concerned about the upcoming wave of loan maturities from the 2006/2007 period and continue to avoid purchases in this sector until there is better clarity on its long-term prospects.

The ABS market, backed largely by credit card and auto loans, continues to look somewhat overvalued and faces a number of regulator uncertainties akin to CMBS. We continue to monitor this market for future investment opportunities. ▲

About Morgan Asset Management

Morgan Asset Management is an active investment manager focused on achieving long-term investment goals for our clients through diversified, high-quality portfolios. We offer a variety of domestic fixed-income and equity strategies, as well as several liquidity/cash management products.

Our proven philosophy and established processes give us consistent long-term performance. We are committed to building long-term relationships by providing enhanced performance and excellent client service. We have the ability to customize portfolios to meet individual client needs and objectives.

Through our relationship with Regions Morgan Keegan Trust, we are proud to serve corporations, public funds, healthcare and insurance companies, educational institutions, Taft-Hartley plans, endowments and foundations, employee benefits, defined contributions and retirement plans and individuals. We have offices throughout 16 states and are able to provide superior local service to all of our clients.

We look forward to serving you. For more information, please contact us at 1-866-917-8730.



Important Disclosures

The foregoing represents the opinions of the author and not necessarily those of Morgan Asset Management or Regions Morgan Keegan Trust. Information contained herein has been derived from sources believed to be reliable but is not guaranteed as to accuracy and does not purport to be a complete analysis of the security, company or industry involved. Opinions regarding any securities mentioned are subject to change at any time. Neither the information nor any opinion expressed, constitute a solicitation for the purchase or sale of any security. Morgan Asset Management does not assume any liability for any loss that may result from reliance by any person upon any such information or opinions. The securities and other investment products described herein are: (1) not insured by the FDIC, (2) subject to investment risks, including possible loss of principal amount invested, (3) not deposits or other obligations, (4) not guaranteed by Regions Financial Corp. or any of its affiliates, and (5) not insured by any Federal Government Agency.