

July 2009

“Dog Days of Summer” and Supranationals

By Jill King, Vice President, Senior Portfolio Manager

Remember when the “Dog Days of Summer” – those hot days of late July and early August – were the quietest and least stressful days of the year? We can recall when this period was best-known for summer vacations, market lulls and a listlessness and languor that inevitably accompanied the season’s warmest days. In the past two years, however, the “Dog Days of Summer” have been anything but slow and relaxed. Two years ago this month, Bear Stearns’ mortgage-inflicted hedge funds collapsed. One year ago, oil prices were approaching \$147/barrel and Lehman Brothers was just about ready to implode. Needless to say, with earth-shattering events like these, the ‘typical’ summer slowdown simply hasn’t existed the past few years. Here’s hoping that this year’s “Dog Days” won’t be nearly as crazed and chaotic as in recent years.

We’re beginning to see some indications that the environment is beginning to normalize. Incoming data and improving financial markets hint that the recession is nearing an end. The consumer remains at the heart of the updated outlook: layoff activity is beginning to slow down and the housing market is showing signs of stabilization. The Fed will continue to provide support for the economy through accommodative policies. With a subdued inflation outlook, the Fed should be able to provide whatever stimulus the economy needs to return to a maintainable norm.

We continue to look for opportunities to provide yield enhancement for our clients. One sector that we have found to be particularly attractive is Supranationals. A Supranational is an entity that is formed by two or more central governments through international treaty. Supranational organizations generally focus on economic growth especially in less developed areas, environmental projects, renewable energy and social goals within a targeted region. The International Bank for Reconstruction and Development (The World Bank) and the Inter-American Development Bank (IADB) are two examples. Importantly, the largest USD supranational issuers are all AAA-rated, carry a 0% risk weighting and fall into the Barclay’s (formerly Lehman) Government-Related index.

Historically, Horizon had not purchased Supranationals such as IBRD and IADB because they were usually issued beyond our 2-year stated final maturity and traded flat or rich to U.S. agencies. This relationship reversed, however, when Fed intervention drove U.S. agency spreads tighter. Dollar-denominated supranational issuance has increased substantially in 2009. Two-year supranational issuance has increased from a total of \$6 Billion issued in 21 deals in 2008 to \$14.1 Billion issued in 15 deals halfway through 2009. Supranational bond issues are structured very similarly to US Agency deals and compete for investor money with U.S. Agencies and Temporary Loan Guarantee Program (TLGP) paper. New issuance has increased primarily due to the expanded role Supranationals are playing in supporting economic recovery and social goals. At the same time, spreads in the sector are poised to narrow as non-government markets re-open, helping to offset the “crowding out” effect from government guaranteed issuance that pressured spreads in late 2008 and 2009. We believe this is an opportunity to take advantage of now before Supranational spreads tighten, as TLGP spreads have over the past several months.

Many new supranational issues have been issued as with a “step-up” structure – a structure that we have actively purchased in U.S. agencies. A “step-up” is structured with a current-to-slightly-lower coupon in the first period which “steps-up” to a higher coupon at pre-determined dates. This type of structure is “defensive” because it provides protection if interest rates are raised during the 2-year stated maturity. One example of a new IBRD issue is:

IBRD 1.40% to 4/14/11, 3% to 4/14/11 Callable on 4/14/10 1% Yield to Call, 2.11

We feel supranationals are a prudent way to add additional alpha to your portfolio. If you’d like us to add supranational bonds to your list of instruments approved for inclusion in your portfolio, please click [here](#) to download an amendment to your Investment Agreement. Simply sign, date and return this amendment to compliance@horizoncash.com. Upon receipt, we’ll add supranationals to your approved list. Of course, if you have any questions regarding supranationals – or any other aspect of your portfolio – please don’t hesitate to contact us.

As this year’s “Dog Days of Summer” unfold, we hope for the return of a more relaxed and normal pace of activity, and we wish you the happiest of summertime activities.

Opinions expressed are those of Horizon Cash Management and are not intended to be a forecast of future events, a guarantee of future results or a recommendation. Horizon makes no assurance that securities discussed within will remain in or out of portfolios. Investing involves risk, including possible loss of principal.