

Looking for Direction

2012 US Interest Rate Forecast *from* Cardea Partners



2012 Rate Projections



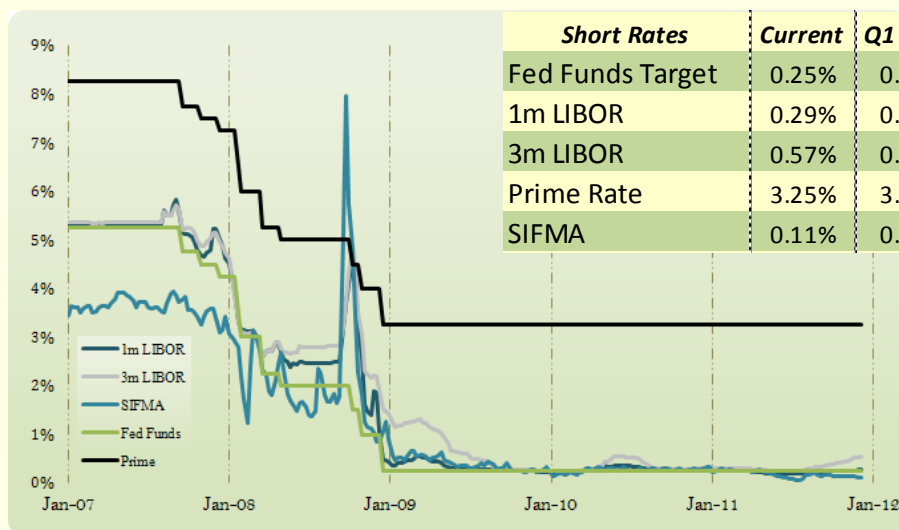
We'll Take the Low Road...

Well, at least we were wrong early in 2011! Our call for Fed tightening and a gradual drift upward for rates at the end of this year was thrown off course quickly by several factors. First, the tsunami rocked Japan and dampened global growth and strained domestic employment. Next, the downgrade of the US debt (which of course made it more desirable to investors!) gave us another glimpse at how global economic mechanisms are too complex for governments to quickly manage. And lastly, the shocking debt burdens overwhelming our European brethren reminded us again of the dangers of over-leveraging. While our fundamental premise from last year, that the US economy and employment would improve over the course of the year, was generally accurate, these three factors, and the responses from the Fed and the ECB to combat them, forced market yields to all-time lows and asset prices to move mostly based on fear and liquidity in a risk-on, risk-off fashion.

The EU problems have roiled markets for months, and our expectation is that the maximum pain from the EU fiasco will be felt in the first half of 2012, forcing investors again to the relative safety of US Treasury notes across the curve, driving the demand for unquestionable assets as global banks shoot first then beg for mercy. Most prognosticators believe that all rates will rise in 2012 (as usual), and their aggregate projected curve is roughly 50 basis points higher than ours beyond the 5-year point. We suspect that Greece, Spain, and/or Portugal could be ejected from the EU, at which point Germany and France will backstop the remaining EU members, or the entire union will collapse in a free-for-all. Our base-case does not call for the collapse of the currency next year.

These events will lead any contracts with perceived credit risk to cost more than logic would otherwise dictate. We believe that lending in the US will actually be perceived as less risky than most other capital deployments for the coming year, which should help distressed assets clear the market, although probably at still-depressed prices. QE3 may be avoided as the rest of the world buys US next year instead of the Federal Reserve, but short term rates likely aren't rising much.

Historical Short Term Rates and 2012 Forecasted Levels



Short Rates	Current	Q1 2012	Q2 2012	Q3 2012	Q4 2012
Fed Funds Target	0.25%	0.25%	0.25%	0.25%	0.25%
1m LIBOR	0.29%	0.35%	0.33%	0.31%	0.28%
3m LIBOR	0.57%	0.64%	0.62%	0.57%	0.55%
Prime Rate	3.25%	3.25%	3.25%	3.25%	3.25%
SIFMA	0.11%	0.26%	0.25%	0.25%	0.20%

The Federal Reserve will have kept its overnight lending rate near zero for almost five years if they continue along the current policy trajectory (12/2008 – 6/2013).



The Continuing Cost of the American Government

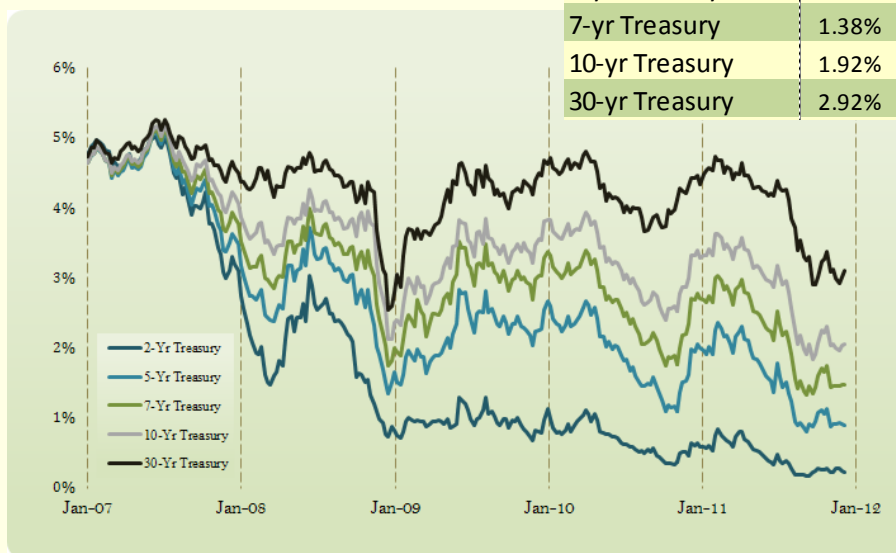
2011 was a year in which many markets whipsawed dramatically, but ultimately drifted sideways or lower. Positives in the economy were sparing enough that the Federal Reserve implemented 'quantitative easing II' in order to stave off a double-dip recession, which seemingly worked. While the Fed's balance sheet remains bloated as it continues to buy assets, the move has kept longer term interest rates in check to the benefit of borrowers whose loans support the free flow of real assets.

Since Treasury yields fall in any global panic scenario, we see the yield curve dropping yet again in the first half of 2012 as European concerns reach a crescendo of fear. Once this occurs, we feel that taking exposure to yields beyond five years will make sense, whether that comes from hedge funds shorting bonds or from more fixed rate payers in the swap market. Shorter maturities will remain low and range-bound for some time due to the Fed's low target rate promise, and investors with short-to-medium time horizons will still gravitate to this part of the curve. This reality will persist until other short dated assets begin to offer better yields, or if marginally higher yielding sources have an improved credit perception in the market.

As the government continues to fund a massive deficit and their borrowing costs remain so low relative to historical levels, we may see the government shift issuance further out on the yield curve, pushing the average duration of the Treasury debt out closer to 7-10 years, much as the Fed's Operation Twist has shifted its purchase profile of Treasuries further out in time. This supply increase will likely force yields higher on the long end over the long term. The new record low yields we see in 2012 will only be revisited if a period of true deflation arrives, so if you are able, take advantage.

Historical US Treasury Yields and 2012 Forecasted Levels

Treasury Yields	Current	Q1 2012	Q2 2012	Q3 2012	Q4 2012
2-yr Treasury	0.26%	0.15%	0.20%	0.25%	0.35%
5-yr Treasury	0.86%	0.70%	0.75%	0.80%	1.15%
7-yr Treasury	1.38%	1.20%	1.35%	1.55%	1.70%
10-yr Treasury	1.92%	1.50%	1.95%	2.25%	2.35%
30-yr Treasury	2.92%	2.60%	2.75%	3.25%	3.25%



Even though we saw new all-time low yields for the 2-year Treasury through the 10-year Treasury in 2011, those rates are likely to be breached as Europe comes to terms with its debt crisis early in 2012.



Swap Duration, If At All

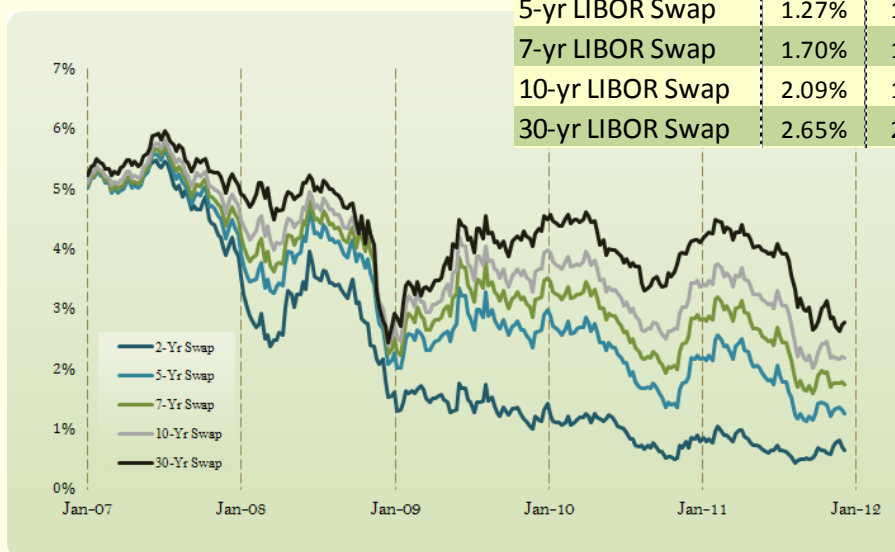
Like much of the Treasury market, swap rates found new lows in the late-summer panic of 2011. The swap curve has flattened, as the long end of the curve fell further below Treasuries at the 30-year point and the short end of the curve continues to retain a liquidity premium. The two year swap is now closely linked to the dollar swap line costs from foreign central banks at the overnight index swap rate (OIS) + 0.50%, since this pricing and liquidity will be available for at least the next two years. Banks have to weigh these funding sources against each other from a cost and credit perspective, and currently credit quality is winning the day.

Our expectation is for swap rates to continue lower until the fear in Europe reaches absurd proportions. LIBOR will continue to rise quietly in this scenario, but we expect the market panic to only last several weeks, and at this point, when 3M LIBOR's premium to the Fed funds target reaches 40 basis points, we expect swap rates to bottom. This won't mean that swaps will be the best solution for all of our clients at this point, but it will mean that the market's gyrations will force policy makers into extreme and decisive action—either with more guarantees or forcing the worst debtors to deal with the consequences on their own. When either occurs, the LIBOR swap market will breathe out and then slowly inhale/reflate, with rates moving higher for longer maturities.

We expect the crisis/resolution in Europe to affect Treasury yields and swap rates in a similar fashion, and the spreads between the two will first compress further at the beginning of the year, and then expand gradually towards year-end, although the 30-year swap spread will remain negative as we close out 2012, as it has for the past four years.

Historical 3M-LIBOR Swap Rates and 2012 Forecasted Levels

Swap Rates	Current	Q1 2012	Q2 2012	Q3 2012	Q4 2012
2-yr LIBOR Swap	0.73%	0.72%	0.60%	0.60%	0.65%
5-yr LIBOR Swap	1.27%	1.20%	1.20%	1.25%	1.35%
7-yr LIBOR Swap	1.70%	1.55%	1.75%	1.95%	2.10%
10-yr LIBOR Swap	2.09%	1.65%	2.20%	2.50%	2.70%
30-yr LIBOR Swap	2.65%	2.20%	2.45%	3.00%	3.10%



Because the Federal Reserve has said its target rate won't rise until mid-2013 at the earliest, short term swap rates are more reflective of market credit concerns and funding availability than when the Fed will move, a concern which shows up more in longer-dated swaps.



2012 New Year's Resolution—Thinking Twice About Swaps

We always like to remind our clients and friends that a vanilla swap rate is the market's expectation for LIBOR's average over a given term. Today's 2.09%, 10-year swap rate says the market expects 3-month LIBOR to average this rate over the next decade, adjusted for time-value of money. If you enter into a 10-year swap and five years roll by, your 10-year rate now gets compared to the current 5-year swap rate for valuation purposes. As such, 99%+ of fixed rate payer swaps executed in the last decade have a negative mark-to-market. In other words, almost everyone would be economically better off without their swaps! Well, if that is the case, why do people keep swapping? A number of factors play a role, but two in particular come to the forefront: (1) lenders often require them with loans today, and (2) other available, "cheaper" hedges require a cash payment upfront. In any rate environment, "winning" the swap game, i.e. paying less than you receive, is challenging, and often not the point of the game. In this environment, playing the game, let alone winning, is even harder, and so it makes all the more sense to explore with your advisor every available hedge product, scrutinize the pricing (no, swaps aren't "free"), and make sure both components fit the business plan.

Which hedging contracts are completely analogous to insurance? Options, not swaps. Purchased options always protect against a liability, they never create one for you. Swaps are certainty, and buying certainty has many costs. Give us a call to discuss what structures makes sense for your organization. With options, like insurance, you don't want the risky outcome to occur, even though you have paid for the protection. You don't want your house to burn down, and you don't want variable rates to rise, but if they do, you've bought enough insurance to cover the liability.

Let us negotiate on your behalf for better pricing, better products, and ultimately the flexibility to adapt in the future to our continuously compounding and changing economy. Give us a call with questions before you agree, sign, or verbally execute anything! If we can help, we will tell you how, if we can't, you have the free blessing of experts to continue on your current path. Most of all, may 2012 bring good health and happiness to you, your organization, and your family.

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<i>Other Markets</i>	<i>Current</i>	<i>Q1 2012</i>	<i>Q2 2012</i>	<i>Q3 2012</i>	<i>Q4 2012</i>
Dow	12100	11250	11750	12250	12000
S&P 500 Index	1241	1050	1100	1160	1125
GDP QoQ	2.50%	2.00%	2.00%	2.50%	3.00%
EURUSD	1.31	1.20	1.18	1.20	1.25
VIX	24%	40%	35%	20%	20%

Disclosure



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