

Market Overview | U.S. Treasuries (earning a 4.68 percent total return) were the preferred investments in the second quarter due to a global flight to quality. The current feeling in the market seems eerily similar to that of late 2008. Bonds outperformed stocks in the first half of 2010 by the widest margin in nine years with Treasuries outpacing all bond-market sectors in the second quarter. A key contributor to Treasury performance was the ongoing sovereign-debt crisis in Europe. Fear in the euro zone continued to dominate trading despite a \$1 billion debt backstop from the European Central Bank. The credit-default-swap market is now effectively pricing in a high probability of orderly debt-restructuring in the European Union (EU). After much debate, it appears EU nations are choosing austerity over stimulus in the face of mounting debt and a declining euro. Investors likely will continue to monitor the euro zone closely because austerity will almost certainly curtail near-term economic growth.

Elsewhere, the Gulf of Mexico oil spill added additional stress to the capital markets and damage estimates are increasing on a weekly basis. The resulting uncertainty constricted liquidity in the market and that likely will persist until the leak is plugged. The market also paid close attention to economic releases, looking for confirmation of a sustained recovery. First-quarter gross domestic product (GDP) initially met expectations but was revised down twice to a 2.7 percent annualized rate. Employment numbers appeared encouraging until accounting for U.S. Census hiring and were also subsequently revised lower. Even more concerning, the housing market began declining once the home-buyer tax credit ended in April. The government since has extended the closing deadline to the end of August. In summation it appears that, absent continued economic stimulus, the economy remains quite fragile.

The Federal Reserve Still Watching the Recovery, Holding Rates Steady

The Federal Reserve maintained its short-term interest-rate target of 0 percent -0.25 percent throughout the quarter and the yield curve flattened materially due to the tremendous rally in Treasuries. Any speculation of a rate increase was put to rest by renewed weakness in the economy, fears of deflation and heightened stress in the capital markets. Instead, the tone has turned from removal of liquidity to potentially injecting more liquidity via the purchase of securities in the open market. The Fed ended its mortgage-purchasing program at the end of March, yet its balance sheet continues to hold record amounts of securities. Our view is that the Fed will expand its balance sheet further if the market seriously deteriorates in the latter half of 2010. We believe that, all things considered, inflation probably is not a serious concern for the market in the near term. Currently the market believes deflation is the larger threat; however, the Fed will not likely allow a broad-market sell off without intervention.

Corporate Market Review | The corporate-bond market meaningfully broke the tightening trend of late 2009 and early 2010 in the second quarter. The option-adjusted spread of the Barclays Capital U.S. Credit Index widened by 55 basis points, signifying to us the return of risk premiums to the market. Still, the majority of the widening took place in May. Spreads actually stabilized in June despite a continued rally in Treasuries: a somewhat uncommon occurrence. In addition, lower-rated bonds only slightly underperformed less-risky bonds (BBB bonds underperformed AAA bonds by just 36 basis points). Historically, higher-risk bonds generally have more drastically underperformed those with lower risk in flights to quality. This divergence is most likely due to a lack of sufficient liquidity in the market. Our view is that while Treasury yields may not remain at their 2010 lows, corporate-bond spreads likely have further to widen in the future. The new-issue market slowed considerably in May and June: another development that worries us. That may create a back-log of new bonds that will need to come to market sooner rather than later. We will continue to search the new-issue market for quality names at discounted prices.

Our stance remains defensive. We continue to maintain our underweight in financial institutions, given what we view as the substantial uncertainty surrounding financial regulation as well as a flattening yield curve. Our focus remains on high-quality industrials with recurring cash flows and sufficient liquidity to weather another downturn in the economy.

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Separately Managed Accounts:

Taxable:

High Quality Taxable
Core Fixed Income
Managed Income Solutions

Tax-free:

High Quality Tax-Free
Special Fixed Income
Managed Income Solutions

Mutual Fund:

Investment Grade
Bond Fund

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Investment grade refers to fixed-income securities rated BBB or better by Standard & Poor's or Baa or better by Moody's.

Convertible securities and preferred stock combine the fixed-income characteristics of bonds with some of the potential for capital appreciation of equities and, thus, may be subject to greater risk than pure fixed-income instruments. Unlike bonds, preferred stock and some convertible securities do not have a fixed par value at maturity, and in this respect may be considered riskier than bonds. Convertible securities may include convertible bonds, convertible preferred stocks and other fixed-income instruments that have conversion features.

Investments in high-yield bonds and convertible securities are subject to the client's authorization, as set forth in the Investment Management Agreement. Such investments may be subject to greater risks than other fixed-income investments. The lower rating of high-yield bonds (less than investment grade) reflects a greater possibility that the financial condition of the issuer or adverse changes in general economic conditions may impair the ability of the issuer to pay income and principal. Periods of rising interest rates or economic downturns may cause highly leveraged issuers to experience financial stress, and thus markets for their securities may become more volatile. Moreover, to the extent that no established secondary market exists, there may be thin trading of high-yield bonds, which increases the potential for volatility.

Municipal Bond Market | Coupled with the modest gains from the first quarter, year-to-date performance is positive all along the curve in the municipal market. April exhibited weakness in the first half of the month but less tax-selling pressure and the recalibration process of municipal ratings helped rally the market for a positive month. May saw continued flow into municipal-bond funds and limited tax-exempt supply. And finally, June was characterized by low trade activity and low issuance (down 45 percent from the year-ago period). June saw yields drift higher during the first three weeks amid increasing credit concerns stemming from municipal issuers' negative media attention. However, municipal-to-Treasury ratios were too compelling to ignore and investors stepped in from the sidelines in the last week.

Municipal returns were positive for the month but they could not keep pace with the tremendous flight-to-quality rally in Treasury bonds. The lagging performance has resulted in municipal-to-Treasury ratios that are well above historic averages. A general-obligation municipal bond rated AAA historically has yielded 80 percent-85 percent of a 10-year Treasury bond. The current 10-year municipal-to-Treasury ratio of 94 percent aids in our search for relative value, which was more difficult in the first quarter. However, yields are also at near historic lows and may not be as attractive on an absolute basis. We have been cautious on purchases because further price appreciation may be a challenge. We believe municipals are well-positioned for outperformance later in the year as the Bush-era tax cuts expire and Build America Bonds continue to hinder tax-exempt supply.

Build America Bonds (BABs) have become an extremely important factor in the municipal market. Issuance statistics reveal that BABs have greatly limited tax-exempt supply. Overall supply in the municipal market has increased 2 percent year to date from 2009 although tax-exempt supply has decreased roughly 22 percent year over year. BABs will continue to limit tax-exempt supply, compounding the effects of increased demand from higher taxes. Legislation to extend the BAB program has not been passed but it is clear to us that most market participants wish to see the program continue in some form or another. However, we believe the long end of the municipal market will see fairly significant increases in yields if the program is not extended. We view it as highly likely that BABs will be extended at a lower subsidy rate but we have remained focused on the intermediate maturity range, which we continue to view as most attractive.

In addition to focusing on the intermediate area of the municipal market, we have maintained our bias toward quality. Higher-rated bonds outperformed lower-rated bonds in June but still lagged for the quarter and on a year-to-date basis. This may be partly attributed to the rating-scale recalibrations by Moody's and Fitch. Many issuers' ratings moved higher by one to three notches and, while difficult to gauge, it appears some spread-tightening resulted. Fundamentally, issuers are still in the same uncertain situations and tighter credit spreads simply do not make sense given the current environment. The media coverage of the municipal market and budget deficits faced by the states picked up during June and will likely continue through the summer and fall. Most states are constitutionally required to enact balanced budgets and many are making tough choices to meet that demand.

Another common theme in the news is related to pension obligations faced by state and local governments and a focus on the excessive benefits public workers receive. Some of the articles may tend to make investors nervous but there have been some positive outcomes from the stories. Public anger has given legislators a stronger position when negotiating with unions. Some states have had success in reducing or changing benefits for new employees and/or requiring higher contributions from existing employees. Those moves may begin to show benefits down the road. We are monitoring these negotiations as well as state budget hearings and the effects those may have on local governments. We currently favor essential-service revenue bonds that typically have a monopoly in the areas they serve and historically have more stable revenues than general-obligation bonds tied to tax receipts. We will continue to monitor existing positions with care and invest cautiously in new issues that provide enough compensation for the risks currently faced by the issuer and the municipal market as a whole.