

Fixed Income Comments—1st Quarter 2012

The first quarter of 2012 continued to benefit from the actions taken by the European Union (“EU”) and the European Central Bank (“ECB”) in the fourth quarter of 2011, combined with improving economic performance here at home. The EU agreed to a second bailout package for Greece, which included the implementation of private sector involvement (“PSI”), resulting in a write-down of approximately 75% of par for holders of Greek government debt and ideally putting Greece on the path to achieving a target debt to Gross Domestic Product of 120% by 2020.

Treasuries were the worst performing asset class for the quarter generating a negative return of 0.48%. With a global financial crisis averted, investors began to unwind the flight-to-safety trade from 2011 by selling Treasuries and putting upward pressure on interest rates, resulting in negative returns for Treasuries. The strength of key fundamental economic data during the quarter, especially when compared to expectations, also contributed to the selloff in Treasuries. The Federal Reserve is continuing to repeat its commitment to keep the Federal Funds rate at or near zero into 2014 and if the economy is truly reaching the point of sustainable recovery and expansion, fears of inflation will eventually take center stage.

Corporate bonds outperformed all other asset classes in the quarter, returning 2.75%. Unlike Treasuries, the tightening of corporate credit spreads more than offset the rise in Treasury rates, leading to a positive return on the Barclays Capital U.S. Intermediate Government/Credit Index of 0.61% for the quarter. Within corporate bonds, financials returned 4.83%, significantly outperforming industrials and utilities which returned 1.54% and 1.14%, respectively. Financials, which underperformed in the third quarter of 2011 as fears escalated that a European financial institution would fail due to lack of liquidity and lead to a repeat of the financial crisis, are benefiting as this risk has essentially been eliminated by the actions of the ECB. Of all the actions the ECB implemented, the Long-Term Refinancing Operations (“LTRO”) was the most significant. These three-year loans to EU banks, totaling over \$1.3 trillion at 1%, provide sufficient liquidity to meet potential needs in 2012 in the event they cannot access the capital markets. The loans also reduce the need for forced selling of assets, including sovereign debt of the distressed periphery countries of Europe. Before the ECB stepped in, asset sales to raise cash were putting downward pressure on prices, driving up interest rates and the cost of financing deficits for the

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weakest countries in the EU. The actions of the ECB combined with changes in leadership in Greece and Italy, as well as the passage of a bailout for Greece including the completion of the PSI, have reduced the risk of a near-term event that could negatively impact the global financial market.

In addition to the liquidity provided by the ECB, the economy in the U.S. is showing signs of improvement, contributing to the tightening of corporate credit spreads. Among some of the examples is the acceleration in auto sales to a 15MM seasonally adjusted annual rate of sales, the highest since early 2008. Private payrolls have increased to over 200,000 per month and have averaged over 214,000 per month for the last six months. The ISM Non-Manufacturing Index, which measures the health of the service sector, has moved up to its highest levels since early 2011 and is essential to driving continued job growth with over 70% of GDP accounted for by the service sector. Manufacturing has seen a resurgence, adding over 120,000 jobs in the last six months and 227,000 over the last two years after contracting for the better part of the last decade. The strength in manufacturing is partly attributable to the improved competitive position of domestic manufacturers due to the value of the dollar and inflation outside the U.S. The housing sector, after having been a

drag on economic activity for the last four years, is showing signs of life. Although nowhere near pre-recession levels, housing starts are moving up and are at the highest levels since late 2008. Existing home sales are at the highest levels since the expiration of the home buyer tax credits that subsidized housing activity from 2009 and 2010, and existing home supply is at the lowest levels since before the recession.

Although everything seems to be on track, there are significant market-moving events on the horizon. Not only is this an election year in a highly partisan political environment, but the debt ceiling will need to be addressed again and the Bush tax cuts and payroll tax cut are scheduled to end this year. At the beginning of 2013, the \$1.2 trillion in automatic cuts to federal spending over 10 years agreed to as part of the debt ceiling debate last August take effect with \$100 billion of cuts in the first year. Solutions to these problems are political but if an agreement cannot be reached, estimates point toward a reduction in GDP by approximately 2.8%, potentially pushing the economy into recession. The Federal Reserve is doing all it can to get the economy to achieve sustainable expansion ahead of these potential drains, with commitments of keeping the Federal Funds rate near zero into 2014 and speculation of

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additional large-scale asset purchases to keep interest rates and the cost of borrowing low. Their current Maturity Extension Program and Reinvestment Policy—also known as Operation Twist, which is intended to lower longer term interest rates—is scheduled to end in June. As the end of the two prior large-scale asset purchase programs neared, interest rates began to move higher and equity and corporate bond valuations weakened. Additionally, while near term worries have abated, the crisis in Europe has not been solved and there is already discussion regarding a potential third bailout of Greece. Furthermore, Spain has already indicated that after implementation of significant spending cuts its budget deficit will be 5.3%, higher than its EU mandated deficit target of 4.4%. Greece is required to meet deficit and structural reform milestones in order to receive disbursements under its bailout agreement. Historically, the implementation of austerity measures contributes to economic weakness and lower government revenues, increasing the likelihood they will miss their deficit targets, resulting in the need for more spending cuts and contributing to a downward spiral of economic weakness.

Given the environment, corporate managements continue to be relatively conservative, maintaining healthy balance sheets with conservative levels of debt. Corporate spreads remain historically attractive given their strong margins, cash flow and conservative balance sheets. Treasury rates remain near their lows, offering limited total return opportunities unless the European sovereign crisis resurfaces and/or political inaction domestically leads to a jump in taxes, combined with significant cuts in federal spending, sending the economy into recession. Politicians can be relied on to find a way to avoid spending cuts and tax increases, and we expect the full impact to be circumvented and with the Federal Reserve continuing to support the economy with easy monetary policy and potential for additional actions we expect the economy to continue its current path of modest growth which is supportive of corporate bond performance.

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The Barclays Capital U.S. Intermediate Government/Credit Bond Index is an unmanaged index composed of all bonds covered by the Barclays Capital U.S. Government/Credit Index with maturities between one and 9.99 years. It is not possible to invest directly in an index.

Free cash flow is a measure of financial performance calculated as operating cash flow minus capital expenditures.

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