

3Q • 2010

Market Overview The U.S. economic recovery continued to slow throughout the third quarter, as interest rates dropped to record lows, with the two-year Treasury falling 18 basis points to 0.42% and the five-year falling 51 basis points to 1.26%. The ten-year also dropped 42 basis points to 2.51%. This flattening comes as a result of disappointing economic news, stagnant private sector hiring, and a “disinflationary” environment. Given this low inflationary period, the fed funds futures are looking out to 2012 before any Fed tightening moves are anticipated.

The unemployment rate remained at a static 9.6%, though 64,000 new payrolls were added by private employers in September. While a positive number, the private sector is not hiring enough to make a significant dent in the unemployment rate or to mitigate job losses by cities and municipalities cutting work forces due to budgetary constraints. Although the inventories of unsold homes increased, the median price of existing family homes increased 0.9% during the quarter (year-over-year). Gross Domestic Product (GDP) continued to stay positive but slowed to 1.7% due to the lack of government stimulus, a cautious consumer, and the trade deficit.

Corporates outperformed after strong second quarter earnings and the European Union (EU)'s announcement to backstop the ballooning debt among several member nations. Mortgage-backed Securities (MBS) posted negative returns due to increased prepayment fueled by record low mortgage rates.

Strategy Review Following the last Federal Open Market Committee (FOMC) announcement voicing explicit concern over CPI at 1.1% year-over-year (Core CPI at 0.9% year-over-year), it appears that another round of quantitative easing is imminent. This would result in a further flattening of the yield curve with the Fed possibly purchasing Treasuries in the 5 to 10 year portion of the curve.

We continue to be overweight in corporates while acknowledging increased event risk due to low corporate financing costs, corporations with lots of cash, and healthy corporate balance sheets that can take on additional leverage. We also continue to be underweight in MBS because of increased rates of prepayment risk and increased originations.

Outlook We remain in the slow economic growth camp and anticipate the low interest rate environment to continue. Given the static unemployment rate, low CPI, continued consumer deleveraging, and positive, but decreasing GDP, we expect the Fed to keep interest rates low for the foreseeable future. Bank CDs and savings accounts are finally mirroring interest rates of money market funds, forcing investors to look further out the yield curve for higher rates of returns. Additionally, the second round of quantitative easing is expected to result in a further flattening of the yield curve.



JAMES M. HANNAN
Managing Director of Fixed Income Strategy, and Co-Portfolio Manager of the MTB Short Duration Government Bond Fund, the Income Fund and the U.S. Government Bond Fund.

Mr. Hannan is responsible for directing the fixed-income strategy and process at MTBIA, and managing separately managed accounts and the MTB Income and MTB U.S. Government Bond Funds. He joined MTBIA at inception in 1995 and has over 20 years of experience trading money market instruments and fixed-income securities. Mr. Hannan earned his B.S. from the University of Maryland and his M.B.A. from George Washington University.



WILMER C. STITH III, CFA
Portfolio Manager Intermediate-Term Bond Fund, Short-Term Corporate Bond Fund, and Co-Portfolio Manager of the Income Fund, and the U.S. Government Bond Fund

Mr. Stith manages the MTB Short-Term Corporate Bond, MTB Income Fund, MTB U.S. Government Bond and the MTB Intermediate Bond Funds, with over 19 years of fixed-income investment experience. He also manages institutional separate accounts with intermediate and long-term fixed income objectives, as well as money market accounts. In addition, Mr. Stith coordinates fixed-income trading for the firm. Prior to joining MTBIA in 1995, Mr. Stith was an investment executive with the Treasury Banking Group of First National Bank of Maryland in Baltimore, Maryland. Mr. Stith earned his B.A. from Kenyon College and his M.B.A. from Loyola College in Maryland.

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References to indexes are made for comparison purposes. Indexes are unmanaged and cannot be invested in directly. Comparisons of fund quantitative measures (such as alpha, beta, etc.) with similar measures of the benchmark index are based on fund holdings as of the date shown, and both account holdings and the comparative statistical relationships are subject to change. Similarly, data with regard to sector allocation, quality distribution, and other holdings-based measures are as of the date shown, and may not reflect current holdings.

Financial and statistical information provided is obtained or derived from sources deemed reliable but is not guaranteed as to accuracy or completeness.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices. Income generated by these funds may be subject to the federal alternative minimum tax.

Mortgage-backed securities (MBS) is a debt obligation or asset backed security that is a claim on the cash flows from mostly residential mortgage loans.

Gross-Domestic Product (GDP) is a measure of the market value of all goods and services produced within a country annually.

TIPS – Treasury Inflation Protected Securities – a note or bond that offers protection from inflation.

Basis Point (often denoted as bp) is a unit relating to interest rates that is equal to 1/100th of a percentage point per annum frequently used to express differences in interest rates of less than 1%.

Core Consumer Price Index is a measure of the price level of consumer goods and services published by the Bureau of Labor Statistics, on a monthly basis.

FOMC – Federal Open Market Committee – creates monetary policy. Mutual funds are subject to risks and fluctuate in value.

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