



Cyril M. Theccanat
President
Chief Investment Officer

Market Review and Outlook July 2010

Review

In July, the fixed income market as represented by the Barclays Capital Aggregate Index posted a total return of 1.07%; global capital markets rallied and volatility fell as transparency from the European Banks stress-test eased sovereign debt fears. In the U.S., all spread sectors outperformed duration-equivalent Treasuries despite generally weaker economic data. The securitized sector had strong performance, beating Treasuries by +51 bp. The residential mortgage-backed sector (MBS) earned +45 bp of excess return as demand for high quality dollar-denominated assets, from both overseas and domestic investors outpaced supply by a wide margin. Sponsorship has been mostly concentrated within the 30-year sector and in GNMA's: conventional 30-year MBS outperformed their 15-year counterparts by +44 bp, while GNMA's outperformed conventionals by +40 bp.

The passage of the Financial Reform Act on July 21st resulted in lower new issuance for the ABS sector as the new law has the potential to increase the legal liability for the Credit Ratings Agencies by exposing them to "expert" liability standards. Although the SEC has granted a temporary exemption, several new issues were withdrawn and/or postponed creating a favorable technical environment resulting in ABS spreads tightening and posting +60 bp of excess return. Commercial mortgage-backed (CMBS) prices continue to move in tandem with the broader markets' appetite for risk and earned +128 bp of excess return. Additionally, the ongoing deterioration in CMBS collateral performance is showing some signs of stabilization. The corporate sector outperformed duration-neutral Treasuries by +123 bp during the month as strong quarterly earnings and a more benign outcome from the Financial Reform Act, coupled with a positive technical backdrop, led to spreads tightening by 18 bp for the overall market. Decreased risk-aversion resulted in lower quality (High Yield +277 bp, BBB + 158 bp) issues outperforming higher quality (Aa +65 bp, A +132 bp) counterparts. Despite market participants' re-engaging in risk assets, the 2-year Treasury yield fell to a record low of .55% on the heels of weaker economic data. The yield curve, as measured by the 2-year/30-year Treasury yield differential increased/steepened by 15 bp to 344 bp.

Most government bond markets in developed countries underperformed the U.S. during the month of July as the return of risk tolerance led to a moderate increase in interest rates, particularly at the front-end of the yield curve. Underperformance was notable for Germany as Greece-related fears abated. Continuing the process of tightening their monetary policy, the Bank of Canada and Reserve Bank of New Zealand raised rates by 25 bp. Reflecting the return of risk taking, the U.S. dollar index (measured against a basket of six major currencies) declined 5.2 % with the commodity-levered Australian dollar gaining the most (+7.5%).

Outlook

The fiscal and monetary programs put in place across many regions of the world after the collapse of Lehman Brothers in September 2008 have continued to provide strong support for global economic growth. However, the sustainability of this economic recovery is being adversely impacted by headwinds on several fronts including the contagion from the European sovereign debt crisis, the slowdown in China, large fiscal deficits in major developed countries and the continued weak housing market in the U.S. Redressing the fiscal imbalances in the European Union will require widespread restrictive fiscal policies across much of Europe which, in turn, is likely to cause a double-dip European recession. China, a major driver of the global economic recovery after the Great Recession, is slowing down as policy makers tighten monetary conditions in response to an over-heating property market. In the U.S., July nonfarm payrolls were softer than expected though contained some mixed signals. Cumulative downward revisions to prior months were a negative; offsetting this were increases in hours worked and earnings coupled with the third consecutive gain in service sector payrolls; the unemployment rate held steady at 9.5%. The manufacturing sector in the U.S. and other countries has softened as inventories have largely been replenished. On a positive economic note, the U.S. service sector survey expanded at a faster-than-expected pace and recent vehicle sales showed strong improvement. Also, senior management teams at several major companies are expressing cautiously optimistic outlooks about improving consumer demand.

The slow pace of recovery in the jobs market coupled with still relatively tight credit conditions particularly for small businesses, 6+ million homes in the foreclosure pipeline, a banking system that is not fully healthy and a benign inflation backdrop are likely to refrain the Federal Reserve from raising interest rates until at least the middle of 2011. In fact, recent reports suggest the Federal Reserve may be considering another round of quantitative easing to fight concerns over deflation.

Our outlook for the securitized sector is unchanged. Limited supply of spread product and significant cash on the sidelines should remain positive for all securitized markets. Furthermore, despite fundamental strains in underlying collateral performance in the ABS and CMBS sectors, valuations in the higher quality-tiers remain compelling, and we maintain our overweight in these sectors. We continue to favor the corporate bond sector as strength in corporate profits, improved balance sheets, low default rates and a favorable technical backdrop should result in a further narrowing of risk premiums through year-end. In particular, we continue to favor the financial sector as asset quality stabilizes, and strong capitalization and robust liquidity coupled with attractive valuations provide excess return potential. Issuer selection, however, continues to be crucial as some companies are shifting their emphasis towards rewarding shareholders through dividend increases, stock buy backs or other measures which could negatively impact their balance sheets. In the non-dollar markets, we believe commodity-levered currencies should be well-supported as sustained evidence of economic growth in emerging markets reduces concerns about waning global growth. Even the Euro is likely to benefit from the string of austerity measures being enacted in Europe. Lastly, we remain underweight Treasuries due to the low yields in the current environment.