



Cyril M. Theccanat
President
Chief Investment Officer

Investment Review and Outlook May 2009

Fixed Income Markets

An improved tone emerged in key economic indicators in May. As a result, the non-Treasury fixed income sectors posted a second consecutive month of strong performance. Better than feared stress-test results from the Treasury regarding capital adequacy of the top 19 U.S. banks set the stage for a powerful rally in the financial sector which spilled over into the other fixed income sectors. Adding to the positive sentiment was the announcement by the Treasury of capital injections in the insurance sector. The U.S. Credit Index's performance in May almost matched April's record performance in terms of excess return, with lower-quality securities handily outperforming higher quality issues. Mirroring the strong performance of the investment grade sector, the High Yield Credit index also posted strong performance in May. The Securitized (MBS, CMBS and ABS) Sector also had a stellar month with ABS posting exceptionally strong results over Treasuries as the Federal Reserve's TALF facility gained greater receptivity. The move by investors away from safe-haven investments together with the overhang of Treasury issuance to fund the widening budget deficit weighed on the Treasury market. Long maturity Treasury yields rose by over 30 bp, while shorter maturity yields increased by 2 to 4 bp resulting in a steeper Treasury yield curve (difference in yields between long and short maturities). Yields in most developed non-dollar markets underperformed the U.S. at the short end as investor risk tolerance increased. Greater risk appetite was more pronounced in the currency markets where the dollar declined by 6.2% against a basket of six major currencies

Outlook

In May, 345,000 jobs were lost in the U.S. pushing the unemployment rate to 9.4%, the highest level in over 25 years. While the employment picture remains weak and consumer spending lackluster, there are increasing signs that economic conditions are improving which could lead to an economic recovery in the second half of this year. The unprecedented monetary and fiscal stimulus measures that have been carried out world-wide since last September are having the desired effect. Housing activity, for example, has rebounded sharply this year in many countries. Construction spending in the U.S. increased for the second consecutive month. Meanwhile the plunge in inventories in many parts of the world in the last quarter of 2008 is setting the stage for a significant rebound in global economic growth as orders have been increasing. The new orders index for the Institute for Supply Management (ISM) survey in the U.S., a bellwether for the manufacturing sector, increased to 51 in May from a low of 23 last December. Depleted auto inventories are likely to result in a 50% increase in vehicle production in the third quarter. Consumer confidence has also risen significantly from its lows last November. This is a positive development for the second half of 2009. Additionally, through May, less than 6% of the \$787 billion stimulus package has been paid out. As additional funds are released, bigger ripple effects will be seen in the economy.

On the monetary front, the Federal Reserve remains committed to maintaining a federal funds rate that is close to 0%. The central bank has also indicated that, if necessary, it will significantly increase its purchase of Treasury and mortgage-backed securities to ensure that higher financing costs do not become a drag on the economy.

While the credit sector has rallied sharply in the last two months, a modest overweight position is warranted because the sector is still cheap despite improving fundamentals. Issue selection, however, remains important. We continue to favor the securitized sectors for their quality (AAA) and attractive yields relative to Treasury and Agency securities. The Federal Reserve's announcement in May that TALF financing would become available for CMBS provides good support for this securitized sector. Also, the Federal Reserve's program to stabilize mortgage rates will continue to have a positive impact on MBS performance. In the currency markets, rising expectations for an economic recovery should support commodity-levered currencies. Lastly, we remain underweight in Treasuries and Agencies.