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Market Review and Outlook Second Quarter 2009

Review

During the second quarter of 2009, the capital markets rallied strongly on optimism that the worst of the financial and economic crisis had passed. Spurred by unprecedented global central bank and government initiatives, along with some "less bad" economic reports, all the non-Treasury sectors of the fixed income markets posted strong performance. For example, the commercial mortgage backed (CMBS) sector generated 1,465 bp of excess return above duration-equivalent Treasuries. Equally impressive, the Credit sector outperformed by nearly 1,200 bp. The Asset-Backed sector also had a strong quarter with an outperformance of more than 800 bp, while Agency debentures and MBS excess returns exceeded 100 bp. Lower quality securities also outperformed; the High Yield Index had a total return of +23.0% for the quarter which represents an outperformance of over 2,500 bp. Decreased risk aversion and the burgeoning supply of Treasury securities (to fund the multitude of government programs), resulted in higher Treasury yields and caused Treasury prices to drop; the Treasury Index had a total return of -3.0%. The Treasury yield curve steepened as longer maturities bore the brunt of rising yields; two-year Treasury yields rose 30 bp while 30-year yields increased 80 bp resulting in a widening of the 2-year/30-year yield differential to 322 bp. In the second quarter, government securities in most developed markets outperformed US Treasuries as non-dollar yields rose less than in the U.S. In the currency markets, the U.S. dollar index (measured against a basket of six major currencies) declined 6.2% as commodity-levered currencies rebounded sharply.

Outlook

Economic data releases have been showing signs of improvement, though the economy is still fragile. The Institute for Supply Management (ISM) survey, a key indicator for the health of the manufacturing sector, rose two points in June which marks the sixth consecutive monthly improvement. Interestingly, the production and employment sub-components of the survey also showed improvement while new orders stalled. On a positive note, inventories continue to be drawn down which could set the stage for a rebound in economic growth later this year. The non-manufacturing (i.e. service sector) ISM report also showed improvement, contracting at its slowest pace in nine months. Since the service sector comprises approximately 90% of the U.S. economy, the better-than-expected report signals that the economy may be poised for growth in the second half of this year. Another indication the recession is easing is that the Leading Economic Indicators Index rose 1.2% in the second quarter; "the first time the index has increased over a six-month period since July 2007" according to The Conference Board. In addition, anecdotal reports suggest that the housing market may be reaching a bottom; home price depreciation is slowing while building permits and housing starts have increased to levels not seen since February. Also, existing home sales rose at a 2.4% annual rate in the most recent reading. Additionally, consumer confidence has improved and retail sales have stabilized. However, a stark reminder of the existing state of the economy is the employment situation. The employment report for the month of June showed that 467,000 jobs were lost, and the unemployment rate inched higher to 9.5%. The U.S. has now lost 6.5 million jobs since December 2007 when the current recession started.

The Federal Reserve's commitment to maintaining a federal funds rate that is close to 0%, paired with the fact that 90% of the \$787 billion fiscal stimulus program remains to be paid out, bodes well for economic

growth later this year. Current expectations are for real GDP to be in the 2%-3.5% range for the second half of the year.

We continue to favor the securitized sectors for their quality (AAA) and attractive yields relative to Treasury and Agency securities. A steady bid for Agency-MBS from the Federal Reserve's quantitative easing program is likely to support the MBS market although valuations are now relatively rich. Prior to the June Federal Open Market Committee meeting, there was widespread speculation that the Federal Reserve might alter its purchase allocation mix between MBS, Agency debt and Treasuries. This led to an increase in MBS spread volatility. However, since the housing market is just beginning to stabilize, we expect little change in the Fed's quantitative easing approach, and, therefore, believe the MBS sector warrants a benchmark weighting. Despite fundamental strains in underlying collateral performance and the recent tightening in spreads, valuations in the upper quality tiers of the ABS and CMBS sectors remain attractive. In the short-term, these sectors can still benefit from an expansion of the TALF and PPIP programs. Longer-term, a stabilizing economy will lead to a gradual improvement in underlying receivable credit performance which will also be positive for these sectors. While the credit sector has rallied sharply over the past few months, our analysis indicates that spreads still remain cheap. Current valuations, coupled with strong demand from retail investors, will lower risk premiums and, thus, the sector warrants a modest overweight position. Issue selection, however, remains important. In the non-dollar markets, expectations for an economic recovery will continue to support commodity-levered currencies. Lastly, we remain underweight in Treasuries and Agencies versus portfolio benchmarks.

Barclay's Capital Indices	Second Quarter 4/1/09- 6/30/09		Year to Date 1/1/09 - 6/30/09	
	Total Return (%)	Excess Return (bp)	Total Return (%)	Excess Return (bp)
Aggregate Index	1.78	365	1.90	430
Intermediate Aggregate Index	1.68	300	2.60	387
Government/Credit Index	1.85	460	0.55	456
Intermediate Government/Credit Index	1.67	360	1.62	380
Treasury Index	-3.02	-	-4.30	-
Agency Index	0.10	155	-0.04	190
US Credit Index	8.81	1187	6.87	1151
Asset-backed Index	7.64	875	15.78	1699
Mortgage-backed Index	0.70	123	2.91	297
Commercial Mortgage-backed Index	12.46	1448	10.36	1281