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Market Review and Outlook Third Quarter 2009

Review

In the third quarter of 2009, the global capital markets continued the second quarter's strong performance as an improving economic backdrop, better than expected corporate earnings and successful government initiatives further bolstered investor confidence. In the investment grade fixed income market, all non-Treasury sectors outperformed duration-equivalent Treasuries with the commercial mortgage backed sector (CMBS) generating the greatest outperformance. The credit and asset-backed sectors also performed well, outpacing the broader market's return by +300 bp (relative to the Barclay's Capital Aggregate Index), while the MBS and Agency Indices generated +111 bp and +42 bp of excess return, respectively. Lower-quality securities performed even better as investors migrated further along the risk spectrum; the High Yield index returned +14% for the quarter compared to an increase of approximately +2% for the Treasury Index. Despite decreased investor risk aversion and a heavy supply of new issuances, Treasury yields fell across the entire curve. Two-year yields fell by 16 bp to 0.9%, while the yield on the 30-year Treasury bond declined 28 bp to 4.05%. This resulted in a 12 bp flattening in the 2-year/30-year Treasury yield curve to 310 bp. Government bond markets in most developed countries underperformed the U.S as yields in the commodity-driven regions rose during the quarter. A notable exception was the United Kingdom which benefitted from the Bank of England's extension of its quantitative easing program. In the foreign exchange markets, the U.S. dollar index (measured against a basket of six major currencies) declined 4.3% for the quarter reflecting a continued move towards riskier currencies.

Outlook

Economic data continue to show signs of stabilization which should enable real GDP to grow by 3% to 4% for the second half of 2009. Although the index for the Institute for Supply Management (ISM) survey, an Indicator of the health of the manufacturing sector, moved lower in September, it is at a level that indicates the sector is still experiencing expansion. The index for the non-manufacturing ISM (i.e. service sector) survey showed expansion for the first time in a year. Additionally, the Leading Economic Indicators Index rose 0.6% for the fifth consecutive month and data from the housing markets show that home prices are beginning to stabilize. There have, however, been weaker data releases; existing home sales declined at a 2.7% annualized rate in August and, reflecting the challenges still facing consumers, the Confidence Index has slipped recently. Additionally, auto sales declined sharply following the expiration of the "Cash for Clunkers" program. Total vehicle sales registered at an annual rate of 9.2 million in September compared to 14.1 million for the prior month. On the employment front, although the magnitude of monthly job losses has slowed to 263,000 in September from the 600,000+ pace earlier this year, the unemployment rate has hit a 26-year high of 9.8%. At its most recent

meeting on September 23rd, the Federal Open Market Committee acknowledged that while “economic activity has picked up”, the Committee “continues to anticipate that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period.” Labor market weakness and the threat of deflation are likely to keep the federal funds rate close to 0% through, at least, mid-2010.

We continue to favor (overweight) the securitized sectors (primarily ABS and CMBS) for their quality and attractive spreads relative to Treasury and Agency securities. The significant compression in spreads to under 100 bp over Treasuries that has taken place over the past few months in the short-maturity, AAA-rated asset-backed sector is a reflection of the success of the Federal Reserve’s TALF program. Due to limited supply, the ABS sector remains attractive for relative value investors as the yields on AAA-rated ABS are a compelling alternative to short Government securities yielding barely more than zero. Despite the recent rally in CMBS, spreads remain wide and offer value. Additionally, imminent buying by the Public- Private Investment Program (PPIP) will further buoy CMBS performance. The agency residential mortgage sector (MBS) warrants a market weight. The Federal Reserve has reiterated its commitment to purchasing the full allocation of \$1.25 trillion in MBS. The end date of the MBS purchase program has also been extended from the end of this year to March 31, 2010. Consequently, the current favorable demand/supply dynamic should support the MBS sector. In the credit sector, we maintain a modest overweight as our analysis indicates credit spreads remain attractive from a historical perspective, particularly for issues in the banks/finance area as well as in industrials (primarily for cyclical companies). Strong demand from retail investors and heavy inflows into corporate bond mutual funds should help spreads compress further. Issue selection, however, remains critical as corporate management teams are beginning to favor shareholders at the expense of bondholders (e.g. tapping the debt markets to pay dividends). In the non-dollar markets, continued concern regarding the sustainability of the global economic recovery is likely to provide a temporary floor for the U.S. dollar. Lastly, the portfolios remain underweight in Treasuries and Agencies versus their respective benchmarks.

	Third Quarter 7/1/09- 9/30/09		Year to Date 1/1/09 - 9/30/09	
	Total Return (%)	Excess Return (bp)	Total Return (%)	Excess Return (bp)
Barclay’s Capital Indices				
Aggregate Index	3.74	198	5.72	640
Intermediate Aggregate Index	3.21	174	5.90	571
Government/Credit Index	4.16	202	4.74	669
Intermediate Government/Credit Index	3.25	157	4.92	546
Treasury Index	2.10	-	-2.29	-
Agency Index	1.82	42	1.63	211
US Credit Index	7.47	498	14.86	1712
Asset-backed Index	6.30	497	23.07	2297
Mortgage-backed Index	2.31	111	5.29	416
Commercial Mortgage-backed Index	12.70	1090	24.38	2507