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## Market Review and Outlook October 31, 2009

### Review

The improving global economic landscape, coupled with better-than-expected corporate earnings, resulted in further outperformance from the non-Treasury fixed income sectors in October. In fact, 85% of the companies that reported quarterly earnings thus far have exceeded consensus expectations. Despite rising loan delinquencies and losses, the commercial mortgage-backed (CMBS) and asset-backed (ABS) sectors continued their third quarter's strong performance and led all other spread sectors with monthly excess returns of +219 and +101 bp, respectively. Positive news on the earning front provided a firm tone for the credit sector which posted +89 bp of excess return. Financials led the way, garnering +162 bp of outperformance over Treasuries. Agency mortgage-backed securities (MBS) recorded their eleventh consecutive month of outperformance (+65 bp) bolstered by the Federal Reserve's MBS purchase program. Although lagging other spread sector returns, even Agency debentures posted a slim advantage over Treasuries (+12 bp). The relatively modest changes in Treasury yields in October mask significant intra-month volatility; the 30-year bond traded briefly below 4% and reached a high of nearly 4.4% before ending the month at 4.23%. Two-year Treasury yields fell 6 bp to 0.9% resulting in a 24 bp steepening of the 2-year/30-year yield differential to 334 bp. Government bond markets in most developed countries underperformed the U.S in October as yields in these regions continued to rise more than in the U.S. The underperformance was more pronounced in the commodity-levered regions and particularly at the shorter-end of the yield curve. The Australian central bank (RBA) raised official rates by 25 bp, becoming the first major central bank to tighten monetary policy. In the foreign exchange markets, the U.S. dollar index (measured against a basket of six major currencies) declined just 0.5% as a strong month-end rally offset earlier declines.

### Outlook

The preliminary reading for third quarter real GDP showed a growth of 3.5% from the preceding quarter. This marks the first increase in quarterly GDP following four consecutive quarterly declines. The composition of the GDP data bode well for future production as inventories continued to be pared down for the sixth consecutive quarter, while real consumer spending rose at a 3.4% pace; government stimulus programs such as "Cash for Clunkers" and the first-time homebuyer tax credit, boosted home sales and were positive contributors to growth. The GDP report also shows that all three major components of consumer spending (durable goods, nondurables and services) increased in the third quarter. In addition, the housing market is showing signs of stabilization with home prices registering the third consecutive monthly increase according to the S&P Case-Shiller Index. *Excluding* the homebuyer tax credit, recent estimates have reported a 7% increase in home sales since January 2009. Even housing starts

have picked up which is another positive sign since the tax credit has had a considerably smaller impact on new home sales. As can be expected in the early stages of a recovery, not all data have been positive; consumer confidence fell short of expectations, declining for the second consecutive month and is likely a reflection of the labor market's persistent weakness. Some of the more recent forward-looking data do show continued momentum in economic activity heading into the fourth quarter. The Institute for Supply Management (ISM), a bellwether for the U.S. manufacturing sector, posted its highest reading since April of 2006. Gains were led by production, employment (first expansion in 15 months) and inventories, while the new orders index remains high despite slipping modestly. Similarly, manufacturing sector surveys around the world surged in October. Auto sales also rebounded in October after slumping the prior month following the expiration of the government's incentives. Away from manufacturing, the services sector survey posted its first consecutive monthly expansion since May of 2008. The employment picture, while improving, remains weak. In October, the US economy lost 190,000 jobs and the unemployment rate rose to 26-year high of 10.2%. One positive in the disappointing report was temporary employment (historically a leading indicator for future employment growth) expanded for the third consecutive month. The Federal Reserve continues to reiterate its intention to keep the Federal Funds rate close to 0%. After its November 3-4 meeting, the Federal Open Market Committee's statement indicated that while economic activity has picked up and household spending is expanding, there are headwinds from on-going job losses, sluggish income growth and tight credit which will keep economic activity weak for some time. As such, we expect the federal funds rate will remain close to 0% at least through mid-2010.

We remain overweight the securitized sectors (primarily ABS and CMBS) for their quality (AAA) and still attractive spreads relative to Treasury and Agency securities. We expect that these sectors will continue to benefit from the government-enacted programs such as TALF and PPIP. Residential MBS valuations are rich based on our relative value analysis; consequently, the portfolios reflect a modest underweight in this sector. In the credit sector, we maintain a modest overweight relative to portfolio benchmarks. Non-dollar markets are likely to refocus on the resiliency of economic data coming out of international markets which could lead to a resumption of US dollar weakness. Lastly, we remain underweight in the Treasury and Agency sectors versus portfolio benchmarks.