



Cyril M. Theccanat
President
Chief Investment Officer

Market Review and Outlook November 30, 2009

Review

Performance in most of the non-Treasury fixed income sectors paused in November despite the economic landscape's continued improvement. The securitized sector modestly outperformed duration-equivalent Treasuries by 29 basis points. This was driven primarily by the residential MBS area which posted +40 bp of excess return (its 12th consecutive positive month), benefiting as the Fed MBS purchase program continues to overwhelm supply. ABS markets experienced relatively light volume during the month as investors looked to lock-in returns before year-end. As a result, the sector lagged Treasuries by -74 bp. Similarly, the CMBS area also posted negative excess returns (-89 bp) as emerging year-end liquidity led to a modest sell-off. On a more positive note, the market saw its first new issue transaction since June 2008, and there are two more deals pending. The conservative underwriting of the deals notwithstanding, their placement is a tentative positive for the CMBS capital market by restarting the flow of capital into CRE loans via this channel. Furthermore, General Growth Property's settlement with CMBS loan special servicers assuaged market concerns about the effectiveness of the bankruptcy remoteness provide by the Special Purpose Entity (SPE) structure (which is designed to segregate trust and parent company assets). In establishing the precedence for loan modifications going forward, the generally CMBS-bond friendly loan modifications agreed upon in the General Growth Property settlement, suggest a scenario where CRE losses, although rising, would remain manageable. In the U.S. Credit sector, excess return of -2 bp was generated as heavy supply and shrinking new issue concessions weighed on the market, coupled with investors pairing back on risk heading into year-end. Meanwhile, Agency debentures posted a modest +7 bp excess return. Treasury yields trended lower during the month as the Federal Reserve reiterated their intention to keep the Federal Funds rate close to 0% for an extended period. Concerns over Dubai's debt problems resulted in a flight-to-quality and a steepening of the 2-year / 30-year yield differential from 334 bp to 353 bp. Government bond markets in developed countries were mixed in November with commodity-levered regions outperforming on the back of some bargain-hunting after significant sell-offs in the previous months. Interestingly, yields declined in most regions even as other risk markets rebounded due to the reaffirmation by major central banks that rates will remain low for an extended period of time. The Australian central bank (RBA) continued to be an exception and raised rates yet again by 25bp during the month, extending the tightening it commenced last month. In the foreign exchange markets, the U.S. dollar index (measured against a basket of six major currencies) declined 1.9% as risk appetite increased.

Outlook

The revised estimate for third quarter real GDP was softer than originally projected but, nonetheless, depicted a gradually improving economy as activity grew 2.8% versus the initial reading of 3.5%. The primary factors in the revisions were broad-based as durable goods, non-durable goods and services were all lower than originally estimated and personal consumption showed a gain of 2.9% versus a previous reading of 3.4%. Trade also had a big impact, shaving .3% from growth due to the strength in imports. Despite these revisions, the composition of the GDP data still provides a positive tone for the future as inventories remain lean and the data for personal income was revised higher (to +1.3% from -.5%) which should bolster consumer spending, prospectively. Anecdotal reports of consumer confidence have improved, driven by the expectations component of the survey while the present situation index is at a 26-year low, probably reflecting the employment landscape. In addition, November auto sales exceeded analysts' expectations, reporting 10.9 million units (seasonally adjusted annual rate) which, excluding the "Cash for Clunkers" program, was the best month figure in a year. Furthermore, pending homes sales surged to the highest reading since March 2006 and home prices posted the fourth consecutive monthly gain. Further evidence of the recovery can be seen in the Institute for Supply Management (ISM) report for November, which while slipping marginally from October (which was at a 3 ½ year high), still indicated expansion for the manufacturing sector. The underlying components of the report are consistent with continued growth as the new orders index made further gains during the month. Another positive sign was that the employment index remained above the breakeven point, indicating expansion of manufacturing jobs. As can be expected in the early stages of a recovery, not all data have been positive; the non-manufacturing ISM index, which measures the services sector activity, unexpectedly contracted in November while recent durable goods orders disappointed the market. The labor market appears to be turning a corner as declines in jobless claims in recent weeks were confirmed by a much better-than-expected November non-farm payrolls report which showed just an 11,000 decline for the month. Cumulative upward revisions to the prior month's figures, along with the unemployment rate declining to 10%, indicate an improving, yet still weak, employment environment. We continue to expect the Federal Reserve will leave the Fed Funds' rate unchanged until the middle of 2010.

The portfolios remain overweighted versus their benchmarks in the securitized sectors (primarily ABS and CMBS) for this area's quality (AAA) and still attractive spreads relative to Treasury and Agency securities. 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 focus on the resiliency of economic data from 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.