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Market Review and Outlook Fourth Quarter 2009

Review

In the fourth quarter of 2009, further evidence of an improving economic backdrop buoyed global capital markets. The Barclays Capital Aggregate Index generated strong excess returns of 105 bp for the quarter, as all non-Treasury sectors outperformed duration-equivalent Treasuries. In the securitized sector, improved liquidity and investor demand for high-quality, short-dated securities led to an outperformance of 100 bp for the sector. The agency mortgage backed (MBS) sector registered another strong quarter beating Treasuries by 75 bp as the Federal Reserve's MBS purchase program tightened mortgage spreads. Furthermore, despite near-record lows in mortgage rates, convexity losses have been limited as a result of benign prepayments due to significant homeowner credit impairment. Reduced issuance in the asset-backed (ABS) sector, despite investor demand, resulted in an outperformance of 168 bp. The commercial mortgage backed (CMBS) was by far the best performing non-Treasury sector earning 374 bp over duration-equivalent Treasuries due to support from government programs such as TALF and PPIP. Additionally, the sector benefitted from its historically wide spreads versus most sectors in the investment grade bond universe. The U.S. credit sector outperformed by 267 bp as a result of improving corporate earnings coupled with attractive historical valuations and strong demand from retail investors. The Agency sector could not keep pace with the overall market as relatively rich valuations led to less spread tightening; however, the sector posted 27 bp of excess return for the quarter. The improved tone in the markets encouraged investors to continue moving further out on the risk spectrum. The High Yield index, for example returned 6.2% for the quarter in contrast to the return of -1.3% for the Treasury index. Two-year Treasury yields rose 19 bp to 1.14%, while the yield on the 30-year bond climbed by 59 bp to 4.64%. The prospects for record Treasury issuance coupled with uncertainty regarding the resiliency of the economic recovery caused the Treasury yield curve to steepen with the 2-year/30-year spread differential widening by 40 bp to 350 bp. Government bond markets in most developed countries outperformed the U.S. While many central banks have acknowledged economic and financial market improvements, they have also signaled their intentions to keep interest rates low for now. The Reserve Bank of New Zealand is an exception as it accelerated the timing of rate hikes to mid-2010 from late-2010. Meanwhile, the Reserve Bank of Australia followed through with its third rate increase of 25 bp in December lifting its target rate to 3.75%. In the foreign exchange markets, the U.S. dollar index (measured against a basket of six major currencies) gained 1.6% as sovereign ratings downgrades of some Eurozone countries caused the euro to weaken by 2.3%. Adding to dollar strength was a 3.6% decline in the Japanese yen on a trend reversal of U.S. dollar carry trades.

Outlook

Although U.S. GDP growth in the third quarter was revised down to 2.2% from the initial reading of 3.5%, the composition of the data is positive. Inventory liquidation for the fourth consecutive quarter along with a sharp pick-up in corporate profits bode well for future growth. Retail sales have gained traction as consumer confidence surveys show improved optimism. In addition, the 11.2 million rate for December auto sales was a significant improvement from the 9.1 million rate in early 2009. Some of the more forward-looking economic data are also constructive. The Institute for Supply Management (ISM), which is a bellwether for the manufacturing sector, expanded in December at its fastest pace in more than three years. The underlying components of the survey exhibit strength with the new orders and production sub-indices sharply higher. Reflecting the synchronized global economic recovery underway, corresponding manufacturing sector indices around the globe are showing expansion. The index for China is at a 20 month high, while the manufacturing sector in the United Kingdom is expanding at its fastest pace in more than two years. There are, however, areas of weakness. In the U.S., the overhang of the number of foreclosed homes continues to weigh on the residential market. New home sales and pending home sales have both experienced sharp declines. Meanwhile, apartment vacancies hit a 30-year high of 8%. In the commercial mortgage market, a record high 6.1% of loans are 30 days or more delinquent. While the employment picture is showing gradual improvement, it remains weak. The much anticipated December jobs report showed an unexpected loss of 85,000 jobs, and an unemployment rate of 10%. At its December FOMC meeting, the Federal Reserve acknowledged the pick-up in economic activity but remained cautious about the outlook as the weak labor market was constraining household spending. While rising commodity prices are an inflation risk, the slack in the economy will help restrain labor costs. As a result, we continue to expect that the Federal Reserve will leave the federal funds rate unchanged until at least the middle of 2010.

Although MBS valuations are rich, the Agency mortgage sector will be supported by the Federal Reserve's MBS purchase program which is expected to continue through the end of the first quarter of 2010. This program which has been an effective stimulus initiative may be continued depending on the pace of the recovery in the housing markets and the overall economy. Despite fundamental strains in the underlying collateral performance in the ABS and CMBS sectors, valuations in the higher quality tiers remain compelling, and we maintain our overweight in the sectors. In the U.S. credit (corporate) sector, we start the year with a continued overweight relative to benchmarks as valuations are still attractive from a historical perspective, particularly for issues in the bank/finance sector as well as in more cyclical industrials. Strong technical factors (demand from retail investors and expectations for lower issuance) should keep spreads firm. In the non-dollar markets, while positive economic data are likely to push interest rates higher, the U.S. dollar may find support from stronger U.S. economic growth relative to Europe and Japan. However, commodity-levered currencies will be underpinned by their better growth profiles. Lastly, the portfolios remain underweight in Treasuries and Agencies versus their respective benchmarks.

Barclay's Capital Indices	Fourth Quarter 9/30/09- 12/31/09		Year to Date 12/31/08 - 12/31/09	
	Total Return (%)	Excess Return (bp)	Total Return (%)	Excess Return (bp)
Aggregate Index	.20	105	5.93	746
Intermediate Aggregate Index	.53	91	6.46	665
Government/Credit Index	-.21	109	4.52	774
Intermediate Government/Credit Index	.31	83	5.24	630
Treasury Index	-1.30	-	-3.57	-
Agency Index	-.10	27	1.53	238
US Credit Index	1.03	267	16.04	1990
Asset-backed Index	1.34	168	24.72	2496
Mortgage-backed Index	.57	75	5.89	495
Commercial Mortgage-backed Index	3.27	374	28.45	2961