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## Market Review and Outlook January, 2010

### Review

After a strong start in the first two weeks of January, a renewed bout of risk aversion weighed on the financial markets for the rest of the month. Fears about the contagion effect from the financial woes facing some of the smaller Eurozone countries coupled with concerns regarding the potential negative consequences from changes being considered to the operating model of large banks drove Treasury yields lower across the maturity spectrum. For the month, the broad fixed income market, represented by the Barclays Capital Aggregate Index, posted a 1.53% total return. The securitized sector led the non-Treasury sectors with an excess return of +48 bp. The residential mortgage-backed sector (MBS) outpaced Treasuries by +25 bp as the sector benefitted from the continued purchases of mortgage securities by the Federal Reserve. Strong demand and light issuance enabled the asset-backed sector (ABS) to outperform by +59 bp. Despite rising delinquencies and defaults, the commercial mortgage backed sector (CMBS) was the best performer in the Index, earning +312 bp over Treasuries. Although the fundamentals in the commercial real estate market remain strained, spreads in this sector more than compensate for the risk, especially at the top of the capital structure. The downturn in the equity markets spilled over into the credit sector which ended the month lagging duration-equivalent Treasuries by -16 bp. Longer-maturity corporate securities underperformed as credit curves steepened. Although the macro-economic data has generally been positive, the Treasury sector posted a total return of 1.6% as yields fell 15 to 36 bp due to increased risk aversion. The Treasury curve also steepened with the 2-year/30-year yield differential widening by 17 bp to 368 bp. Government bond markets in most developed countries underperformed the U.S. as concerns mounted that the financial and economic problems in countries such as Greece, Portugal and Spain would spread to other countries in the Eurozone. In Japan, yields rose, in part, due to the revision of the country's credit rating outlook to negative by S&P. In the foreign exchange markets, the U.S. dollar index (measured against a basket of six major currencies) gained 2% on sovereign ratings downgrades fears. The Japanese yen, on the other hand, gained 3% on a reversal of carry trades.

### Outlook

In the fourth quarter, the U.S. economy expanded at a 5.7% rate, its fastest pace in six years. Inventory re-stocking contributed more than half of the growth. The 7.5% peak-to-trough decline in inventories during this recession is the sharpest decline on record. As a result, inventory replenishment will continue to boost GDP growth over the next year. Recent forward-looking data also have a positive tone. In January, the Institute for Supply Management (ISM) index, a bellwether for the manufacturing sector, reached its highest level since August 2004 with all of the components showing improvement. Importantly, the new orders and production indices were sharply higher, while the employment component remained in expansion territory.

Reflecting the synchronized global economic recovery underway, manufacturing indices in both developed and emerging regions around the world are showing expansion. While the turnaround in the U.S. economy is being led by business spending, consumer confidence has shown improved optimism and retailers are reporting increased “traffic”. Although the January employment report showed a loss of 20,000 jobs, the unemployment rate unexpectedly dropped to 9.7%. Additionally, the manufacturing sector added jobs for the first time in three years, temporary hiring, which has generally been a good precursor for gains in full-time employment, increased and the workweek lengthened. The Federal Reserve expects the pace of economic recovery to be moderate for a while, and for inflation to be subdued due to the substantial resource slack in the economy. Our view is that the central bank will leave the federal funds rate unchanged until, at least, the second half of 2010.

Although MBS valuations are rich, the Agency mortgage sector will continue to be supported by the Federal Reserve’s MBS purchase program until its scheduled expiration on March 31<sup>st</sup>. We will maintain a modest underweight in this sector until the Federal Reserve clarifies its intentions regarding the investment of MBS paydowns from its \$1+ trillion holdings in mortgage securities. Despite fundamental strains in the underlying collateral of ABS and CMBS securities, valuations in the higher-quality tiers remain compelling, and we maintain our overweight in these two sectors. In the credit sector, we maintain a modest overweight as spreads are still attractive from a historical perspective. Additionally, the positive bias in company earnings and strong technical factors (lighter than expected issuance combined with positive cash flows into bond funds) should provide a healthy bid for corporate bonds. The U.S. dollar is likely to remain well-supported due to stronger economic growth in the U.S. relative to Europe and Japan, and also from investors’ fears about the risk to sovereign ratings. Lastly, the portfolios remain underweight in Treasuries and Agencies relative to their benchmarks.