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Market Review and Outlook First Quarter 2010

Review

In the first quarter 2010, the capital markets continued to advance on signs of further improvements in the global economic recovery. The Barclays Capital Aggregate Index generated healthy excess returns of +78 bp for the quarter, as all non-Treasury sectors outperformed duration-equivalent Treasuries. The securitized sector's +127 bp of excess return was driven by the stellar +795 bp of outperformance from the commercial mortgage-backed sector (CMBS) despite rising delinquencies and defaults. CMBS spreads tightened yet again by 40 to 125 bp, a clear indication that market sentiment has improved. The Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF) program, which was designed to stabilize the market for consumer loan-backed securities, has been without question a success in restoring market confidence and pricing transparency in the asset-backed (ABS) sector. ABS spreads compressed by another 20 to 90 bp in the first quarter resulting in +133 bp of excess return for the sector. Despite tight spreads, agency mortgage-backed (MBS) securities again registered a good quarter outpacing Treasuries by +69 bp. The end of the Federal Reserve's MBS purchase program did not negatively impact spreads as the central bank's exit was well-anticipated. Furthermore, a timely positive for this sector has been the technical removal of about \$200 billion in pass-throughs as a result of Fannie Mae and Freddie Mac's buyouts of delinquent loans. The credit sector rallied for the fourth consecutive quarter and generated +113 bp of outperformance as strong earnings, attractive valuations and investors' search for yield tightened corporate spreads by 22 bp. Reflecting the strong performance in the equity markets, the U.S. Corporate High Yield Index posted 4.6% in total return. The Agency sector could not keep pace with the overall market as rich valuations led to less spread tightening; however, the sector still outperformed Treasuries by +32 bp as swap spreads tightened. Despite record new issuance, burgeoning budget deficits and an improving economic backdrop, the U.S. Treasury index posted a total return of 1.12% as short to intermediate maturity Treasury yields declined modestly. In the first quarter, the 2-year Treasury's yield decreased 12 bp to 1.02%, while the 30-year Treasury bond's yield increased 7 bp to 4.71%. This steepened the yield curve by 19 bp to 369 bp. Government bond markets in most developed countries had mixed performance for the quarter. While most markets underperformed the U.S., Germany was a notable exception. The German government bond market benefited significantly from flight-to-quality due to the economic and financial problems in Greece. The spread differential between 10-year Greek and German bonds widened from 238 bp to 344 bp. Another notable event during the quarter was the divergence in performance between the Australian and New Zealand bond markets. Australian yields have been pushed higher as the Reserve Bank of Australia (RBA) raised interest rates in response to stronger than expected economic growth. New Zealand's economy, on the other hand, has been surprisingly weaker despite its close geographic proximity and strong economic ties to Australia. As a result, short maturity New Zealand yields dropped sharply. Reflecting the growing concerns about government finances in Europe, the euro declined 5.5% while the British pound fell 6% against the U.S. dollar. Commodity-levered currencies, on the other hand, gained on optimism that economic growth is gaining traction.

Outlook

The global economic picture is brightening as strong demand from emerging economies such as China and India is enabling manufacturing-led economic recoveries in the U.S. and Europe. In 2010, goods exports from the U.S. are growing at an annualized rate of 26%, while in India, imports have increased at a 105% rate. China also may have its first trade deficit in years. Strong corporate profits coupled with improved financial market conditions are also leading to a surge in capital expenditure spending. The March reading for the Institute for Supply Management (ISM), a bellwether for the manufacturing sector in the U.S., reached its highest level in six years. The breadth and strength of the global economic recovery is reflected in the near-record high for a key global manufacturing index. The consumer is also coming out of hibernation. In the U.S., motor vehicle sales climbed 14% to an 11.8 million rate in March and retailers have become more constructive about consumer spending. While recent housing market indicators have turned up, construction spending remains a big drag on economic growth. The key to a sustainable economic recovery is job creation; the March employment report showed a marked improvement in labor market conditions with payrolls increasing by 162,000, while the unemployment rate held steady at 9.7%. Additionally, increases in the number of temporary workers and in the work week are positive because these two factors have been good indicators of future growth in full-time employment. We still hold the view that the Federal Reserve will not raise short-term rates until, at least, late in 2010. With inflation and inflation expectations still benign, the Federal Reserve will have time to assess the sustainability of the economic recovery underway as the extraordinary 2008/2009 stimulative measures are removed.

We currently remain slightly underweight the MBS sector as the Federal Reserve's agency and passthrough purchase programs end. However, there may be relative value opportunities to increase MBS exposures, especially in higher coupons, once the GSE buyouts are complete. Despite fundamental strains in the performance of the underlying collateral in the ABS and CMBS sectors, valuations in the higher quality tiers remain compelling. In CMBS, some additional positive factors include capital returning to this sector as REIT's have successfully raised capital through equity issuances, some semblance of stability in property prices, and a modest pick up in loan originations under tighter credit underwriting standards. In the credit sector, we maintain a modest overweight, as spreads for financials and deep cyclical industrials are still attractive from a historical perspective. Additionally, the positive bias in company earnings coupled with strong technical factors (lighter issuance) should provide a healthy bid for corporate bonds. Credit selection is becoming more paramount as company management teams have begun to favor shareholder returns versus balance sheet repair/prudence. The U.S. dollar is likely to remain well-supported despite increased risk appetite, primarily due to stronger economic growth prospects in the U.S. relative to Europe and Japan. As the global economic recovery gains traction, commodity-levered currencies such as the Australian and Canadian dollar will continue to find support. Despite recent economic weakness, the New Zealand dollar could be a surprising beneficiary as expectations re-adjust to reflect a higher than expected growth profile going forward. Lastly, the portfolios remain underweight in Treasuries and Agencies relative to their benchmarks.

Barclays Capital Indices	Year to Date	
	Total Return (%)	Excess Return (bp)
Aggregate Index	1.78	78
Intermediate Aggregate Index	1.81	81
Government/Credit Index	1.55	46
Intermediate Government/Credit Index	1.54	44
Treasury Index	1.12	-
Agency Index	1.19	32
US Credit Index	2.27	113
Asset-backed Index	2.22	133
Mortgage-backed Index	1.54	69
Commercial Mortgage-backed Index	9.10	795