



Cyril M. Theccanat  
President  
Chief Investment Officer

## Market Review and Outlook April, 2010

### Review

In April, the broad fixed income market posted a total return of 1.04% as measured by the Barclays Capital Aggregate Index. The non-Treasury sectors had mixed performance with excess returns ranging from -11 bp to +176 bp as improving economic data was offset by escalating concerns about sovereign credit risk in the second half of the month. The securitized sector had a subdued month, outperforming Treasuries by just +4 bp. The residential mortgage-backed sector (MBS) lagged duration-equivalent Treasuries by -11 bp as implied volatility rose. The Fannie Mae MBS sector lagged Treasuries and the Freddie Mac sector by -25 and -21 bp respectively due to the ongoing buyouts of delinquent loans. The asset-backed sector (ABS) was relatively flat versus Treasuries with only the utility sub-sector outperforming by +19 bp. Despite rising delinquencies, defaults and appraisal reductions, the commercial mortgage-backed sector (CMBS) was once again the best performer, generating +176 bp of excess return. The credit sector outperformed duration-equivalent Treasuries by +41 bp bolstered by strong earnings and modest new issuance. The industrial and utility sectors provided +63 bp and +78 bp of excess return respectively, while the finance sector only generated +28 bp as the SEC lawsuit against Goldman Sachs coupled with harsh rhetoric on financial reform took a toll on the bank and finance complex. Treasury yields moved lower by 6 to 20 bp for the month in a safe-haven bid with the 2-year ending the month below 1% at 0.96%. The near-record steepness of the Treasury yield curve provided a strong bid for long Treasuries which resulted in a 14 bp flattening in the 2-year/30-year yield differential to 356 bp. Government bond markets in most developed countries underperformed the U.S. during the month. Canada led the underperformance as stronger than expected economic data pushed Canadian government yields higher. The crisis in Europe caused a flight to the German government bond market pushing German yields lower versus the U.S. for the third consecutive month. Notably, the spread between 2-year Greek and 2-year German bonds widened to just under +1200 bp at month-end, compared to a spread of just 8 bp in September, 2009. Adding to the negative pressure, S&P cut Greece's credit rating 3 levels to below investment grade. Elsewhere, the Reserve Bank of Australia continued its tightening cycle by raising short-term rates another 25 bp to 4.25%. In the foreign exchange markets, the U.S. dollar index (measured against a basket of six major currencies) gained 1% primarily due to the 1.6% decline in the euro.

### Outlook

The U.S. economy expanded by 3.2% in the first quarter of 2010 following real GDP growth of 5.6% in the last quarter of 2009. The composition of the first quarter GDP report is encouraging for future growth as the cyclical rebound unfolds. The primary drivers were consumer spending which rose 3.6% on the strength of a 3.2% increase in wages and salaries. Equipment and software investment increased by 13.4%, while inventories showed the first outright gain in two years as

firms re-stocked on the heels of improving demand. The manufacturing sector continues to lead the economic recovery with manufacturing indices in both developed and emerging regions around the world in an expansionary phase reflecting the synchronized global recovery underway. While same-store sales from retailers were weaker than expected many companies raised guidance due to margin improvement and increasing consumer confidence. The housing market remains an area of concern. The modest pick-up in activity is primarily due to the government's stimulus measures. However, the homebuyer tax credit expired at the end of April, and there is a sizeable overhang of 6+ million homes in foreclosure or in the foreclosure process. On a positive note, the employment landscape is brightening with the 290,000 increase in April non-farm payrolls despite the unemployment rate ticking higher to 9.9% as more job seekers entered the workforce. With net upward revisions to prior months, approximately 600,000 jobs have been created in the first four months of 2010. The household survey shows an even larger 1.7 million new jobs this year which bodes well for income and spending. Despite the improvements in the economy, the Federal Reserve has significant concerns about the strength and sustainability of the economic recovery. Our view is that monetary policy will not be tightened until, at least, late in 2010. The Federal Reserve will want to assess the impact the winding down/expiration of the extraordinary 2008/2009 stimulative measures will have on the financial markets. Additionally, the recent events in Europe are an added uncertainty for the capital markets and the global economies.

We continue to favor the securitized sector (namely ABS and CMBS) despite fundamental strains in the underlying collateral performance as valuations in the higher quality tiers remain compelling. Despite the expiration of the Federal Reserve's MBS purchase program, the GSE's buyout announcement changes the technical prospects for this sector. We expect there will be compelling values in the higher coupons once the buyouts are complete. The sector could also benefit from reinvestment of paydowns during the next several months. We have a market weight in the MBS sector. In credit, we are still positive on the sector from a longer-term perspective but have reduced risk in sectors such as finance and telecom given the current headwinds facing the market. The U.S. dollar is likely to remain well-supported as the European Union continues to deal with its sovereign debt crisis. Additionally, the economic recovery in the U.S. is likely to be stronger relative to Europe and Japan. Although, the continuing global economic recovery is supporting commodity-levered currencies such as the Australian and Canadian dollar, concerns are emerging regarding the contagion effect from the turmoil in Europe. Lastly, the portfolios remain underweight in Treasuries and Agencies although we have removed our overall relative duration underweights.