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## Market Review and Outlook May, 2010

### Review

In May, the fixed income market as represented by the Barclays Capital Aggregate Index posted a total return of 0.84% as global equity markets fell and volatility rose dramatically due to concerns about the European sovereign debt crisis. In the U.S., most spread sectors underperformed duration-equivalent Treasuries as risk aversion increased. Although the securitized sector registered its first monthly underperformance (-23 bp) of the year versus Treasuries, the residential mortgage-backed sector (MBS) outperformed by +2 bp due to its perceived safe-haven status, and the sense that imminent sales of the Federal Reserve's vast holdings of mortgage securities was unlikely. Following stellar performance in the first four months of the year, the commercial mortgage-backed sector (CMBS) lagged significantly in May with an underperformance of -293 bp as investors fled risk sectors. Even the high-quality (AAA-rated) consumer asset-backed securities (ABS) sector was not immune as spreads widened between 10 to 15 bp for the month resulting in -42 bp of excess return. The corporate bond sector sold off sharply with the credit index underperforming by -237 bp as spreads widened by 40 bp on rising fears about the contagion effect from Europe. Higher quality securities outperformed lower quality issues; the corporate high yield index trailed duration-neutral Treasuries by -493 bp. The flight to quality pushed Treasury yields down sharply by 20 to 36 bp across the curve. Strong investor demand for longer maturity issues flattened the 2-year/30-year Treasury yield differential by 11 bp to 344 bp. Relative performance of government bond markets in developed countries was mixed. While yields declined across all regions, the Australian bond market outperformed the U.S. as yield differentials narrowed by 18 to 33 bp despite the Reserve Bank of Australia's 25 bp hike in interest rates. There are heightened concerns about the demand for industrial commodities due to the economic slowdown in China. The Japanese bond market, on the other hand, underperformed the U.S. as yield differentials widened by 19 to 29 bp due to continuing concerns about the government's finances. Japan's debt/GDP ratio, which is approaching 200%, is the highest in the developed countries. In the currency market, the U.S. dollar index (measured against a basket of six major currencies) gained 5.8% as broad-based risk aversion caused all currencies, except the Japanese yen, to fall against the U.S. dollar with the Australian dollar declining the most (-8.5%).

### Outlook

The fiscal and monetary programs put in place across many regions of the world after the collapse of Lehman Brothers in September 2008 have continued to provide strong support for global economic growth. However, the sustainability of this economic recovery is being adversely impacted by headwinds on several fronts including the contagion from the European sovereign debt crisis, the slowdown in China, large fiscal deficits in major developed countries and the weak

housing market in the U.S. Redressing the fiscal imbalances in the European Union will require widespread restrictive fiscal policies across much of Europe which, in turn, is likely to cause a double-dip European recession. China, a major driver of the global economic recovery after the Great Recession, is slowing down as policy makers tighten monetary conditions in response to an over-heating property market. In the U.S., the May employment report showed a disappointing gain of just 41,000 new jobs excluding the temporary census workers. Although the unemployment rate declined by 0.2%, it remains high at 9.7%. There are, however, positive glimmers of light. The manufacturing sector in the U.S. and in other countries remains firm as evidenced by the upbeat surveys for this sector. Vehicle sales are registering at an 11.6 million rate helped by lower fuel prices and rising consumer confidence which is now back to March 2008 levels. Senior management teams at several major companies are also expressing cautiously optimistic outlooks about improving consumer demand.

The slow pace of recovery in the jobs market coupled with still relatively tight credit conditions, 6+ million homes in the foreclosure pipeline, a banking system that is not fully healthy and a benign inflation backdrop are likely to refrain the Federal Reserve from raising interest rates until 2011.

Our outlook for the securitized sector is unchanged. Despite strains in the underlying collateral performance in the ABS and CMBS sectors, and the prospect for further marginal deterioration, valuations in the higher quality tiers remain compelling. As such, we remain overweight these sectors. We continue to favor the corporate bond sector from a longer-term perspective as strength in corporate profits and balance sheets combined with a cyclical rebound should result in a further narrowing of risk premiums through year-end. Issuer selection, however, continues to be crucial as some companies are shifting their emphasis to rewarding shareholders. In non-dollar markets, the U.S. dollar will be underpinned by stronger economic growth in the U.S. relative to Europe and Japan as well as from the safe-haven status of the dollar due to the crisis in Europe. Lastly, we remain underweight Treasuries.