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Market Review and Outlook
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Review

In February the fixed income markets as represented by the Barclays Capital Aggregate Index posted a total return of 0.25%, as improving macroeconomic data was offset by the social unrest in the Middle East/North Africa (MENA). Risk assets performed well as all spread sectors outperformed duration-equivalent Treasuries. Also, longer-dated Treasuries outperformed shorter-dated issues with the Treasury yield curve (2-year/30-year yield differential) flattening 19 bp to 382 bp.

The securitized sector outperformed Treasuries by +27 bp during the month. Agency MBS posted +22 bp of excess return with higher coupon securities outpacing their lower coupon counterparts by as much as 50 bp, reflecting in part the increased guarantee and insurance fees outlined in a recent Treasury Department White Paper. The commercial mortgage-backed sector (CMBS) was a top performer in the Aggregate Index, earning +107 bp over Treasuries. ABS spreads held firm in the asset-backed market as several new-issue deals were several times oversubscribed. Overall, the sector posted 13 bp of excess return. The U.S. Credit sector garnered +62 bp relative to duration-neutral Treasuries as strong corporate earnings coupled with increased inflows into mutual funds, lower new issuance all contributed positively for the sector. Leading the way again was the finance sector which generated +108 bp of excess return while industrials and utilities posted +45 and +48 bp, respectively. Excess returns across the quality spectrum indicate a continued healthy bid for risk assets: Aa +38 bp, A +80 bp, Baa +61 bp and High Yield +144bp.

Government bonds in the developed markets outperformed the U.S. in February. Short-maturity New Zealand government bonds led the rally with rates declining more than 30 bp due to the negative economic implications from the recent devastating earthquake. In the currency markets, the U.S. dollar index (measured against a basket of six major currencies) declined 1.1% despite the turmoil in North Africa.

Outlook

Improving U.S. economic data coupled with the recent extension of Bush-era tax cuts, as well as a 2% reduction in employee payroll tax rates, bode well for consumer sentiment and spending in 2011. Meanwhile, the manufacturing and service sectors are surging both in the U.S. and abroad. Banks are also seeing a pick-up in loan demand. These are all positive catalysts for job creation which is a key factor to ensuring a self-sustaining economic recovery.

Despite the improved tone, stiff headwinds still remain: an unemployment rate close to 9%, housing near recessionary lows, budget deficits at both the federal, state and local levels, rising

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oil/gasoline prices with their "tax-like" effects on consumers, a European debt crisis which is structural in nature, geopolitical concerns in MENA and emerging markets like China and India trying to engineer a soft-landing. As a result, monetary conditions will remain very accommodative, and the Federal Reserve has reiterated its commitment to employ all policy tools necessary to achieve its dual mandate of maximum employment and price stability. The slow pace of recovery in the labor markets, coupled with low core inflation, make it unlikely that the Federal Reserve will raise the federal funds rate until at least late 2011/early 2012.

Although MBS are fairly valued, originations remain light and strong demand from both banks and foreign investors should underpin spreads at current levels. Furthermore, range bound rates and dwindling outstanding volume suggest strong odds for most securitized product to earn incremental carry. We, therefore, have a positive allocation bias in general to these products in our portfolios. We are particularly emphasizing the CMBS sector, as our analysis still suggests the potential for further material spread narrowing. Our outlook for the corporate market is essentially unchanged. We continue to favor the finance sector as valuations still remain compelling on a historical basis versus current industrial and utility spreads. Nonetheless, issuer selection is critical as some companies are shifting towards more shareholder friendly policies in addition to focusing more on growth initiatives via mergers and acquisitions which have the potential for balance sheet deterioration. In the non-dollar markets the continued resiliency in commodity prices supports commodity-levered currencies. Given the current interest rate environment, we still remain underweight Treasuries and Agencies.