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Market Review and Outlook 1st Quarter 2011

Review

In the first quarter of 2011, the fixed income markets as measured by the Barclays Capital Aggregate Index posted a total return of 0.42%. As the quarter unfolded, the economic outlook became less certain amid a rise in oil prices, the turmoil in the Middle East/North Africa (MENA), and the unfortunate disaster in Japan. However, despite the rise in volatility, all spread sectors outperformed duration-equivalent Treasuries.

The securitized sector had a good quarter outpacing Treasuries by +66 bp. Despite tight spreads, agency mortgage-backed (MBS) securities registered a second consecutive strong quarter with an outperformance of +56 bp. Higher coupon MBS led the way on increasing signs that prepayments will remain fairly muted. GSE reform uncertainty and demand from banks and overseas investors helped the GNMA sector outperform its conventional counterpart by 10 bp. The commercial mortgage backed sector (CMBS) was one of the best performers in the Barclays Aggregate Index, posting +203 bp of excess return. Similar to 2010, lower-rated CMBS tranches outperformed their AAA counterparts by more than +200 bp. The consumer asset-backed sector (ABS) performed well, earning +61 bp over duration-equivalent Treasuries as the credit card sub-sector posted strong performance (+77 bp) due to lack of new issuance. In the first quarter, credit card net supply (issuance less maturities) declined \$17 billion. The U.S. credit sector got off to a fast start generating +105 bp of excess return. Similar to the fourth quarter of 2010, investors' search for yield and relative value resulted in financials posting +148 bp of outperformance. The corresponding figures for the Industrials and utilities sectors were +74 and +86 bp respectively. The market's appetite for risk is reflected in the excess returns by credit quality: Aa +72 bp, Baa +160 bp and High Yield + 387 bp. Treasury yields rose 20-30 bp as investors increased risk exposures. The Treasury yield curve flattened with the 2-year/30-year yield differential narrowing 5 bp to end the quarter at 369 bp.

Government bonds in the developed markets had mixed performance for the quarter. The recurring European sovereign debt crisis combined with heightened inflation expectations for the region created a volatile environment that resulted in sharply higher yields in the eurozone. European sovereigns led by Germany underperformed the U.S. by 20 to 70 bp across the curve. The Pacific Rim outperformed the U.S. as yields in New Zealand and Australia declined, while Japanese yields rose by less than the U.S. In the currency markets, the U.S. dollar index fell over 4% (measured against a basket of six major currencies). The expectation for higher interest rates outside the U.S. was the dominant factor for the decline. While the dollar declined by 2.7% to 5.8% against most of the major currencies, it rose by 2.3% to 2.5% against the New Zealand dollar and the Japanese yen as those economies were adversely impacted by major earthquakes.

Outlook

At the most recent Federal Open Market Committee meeting in March, the Federal Reserve provided a more upbeat assessment of the U.S. economy stating that the recovery "is on firmer footing". Despite the improved tone, stiff headwinds still remain: an unemployment rate near 9%, housing close to recessionary lows, budget deficits at both the federal, state and local levels, rising oil/gasoline prices with their "tax-like" effect 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 are likely to remain accommodative, while 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 while demand is strong from banks and foreign investors. REIT buying has also been solid since the beginning of February, potentially becoming a key source of demand for the Treasury's MBS sales. Furthermore, range-bound interest rates and dwindling outstanding volume suggest a strong likelihood for most securitized product to earn incremental carry. We, therefore, have a positive allocation bias to these products in our portfolios. We are particularly emphasizing CMBS product, as our analysis still suggests the potential for material spread tightening. We remain overweight the corporate sector as strong fundamentals underpin spread valuations. Finance sector spreads continue to be attractive from a historical basis relative to industrial and utility spreads, leading us to maintain our overweight. Issuer selection, however, is becoming more critical as an increasing number of companies are shifting their focus from protecting their balance sheet and credit metrics to re-leveraging activities through M&A, share repurchases and increasing dividends. In the non-dollar markets, the threat of a widening turmoil in the Middle East, and a continuation of the European sovereign debt crisis will be headwinds for economic growth. Lastly, we remain underweight Treasuries and Agencies.

Returns

First Quarter 2011

Barclays Capital Indices	Return (%)	Excess Return (bp)
Barclays Aggregate Index	0.42	50
Barclays Intermediate Aggregate	0.48	47
Barclays Government Credit	0.28	41
Barclays Int. Gov Credit	0.34	34
Treasury Index	-0.16	--
Agency	0.27	26
U.S. Credit	0.89	105
Asset-Backed	0.64	61
Mortgage-Backed	0.58	55
Commercial Mortgage-Backed	2.05	203