Market Review & Outlook

1st Quarter 2012

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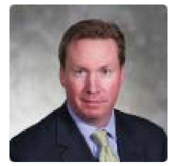

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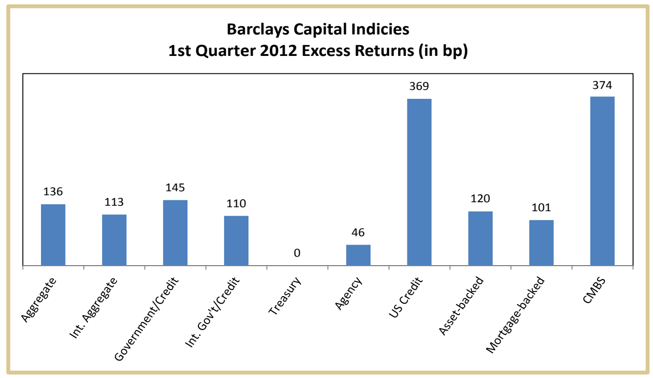
Highlights

- *Economic data indicators have shown a steady improvement over the past few months. However, risks remain for the global markets.*
- *Volatility is likely to remain an overhang for the non-dollar markets, especially in Europe.*
- *We continue to see relative value opportunities across most fixed income spread sectors.*

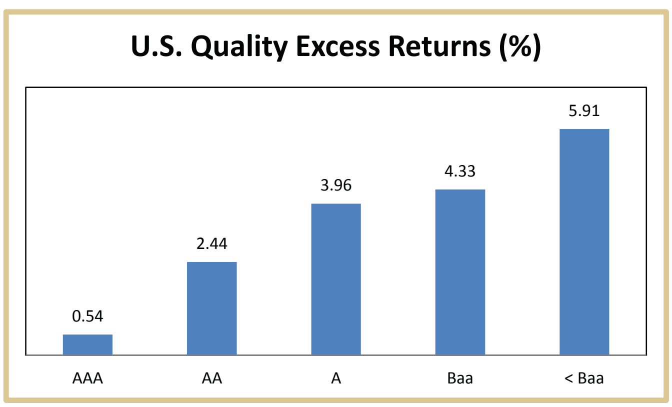
Review

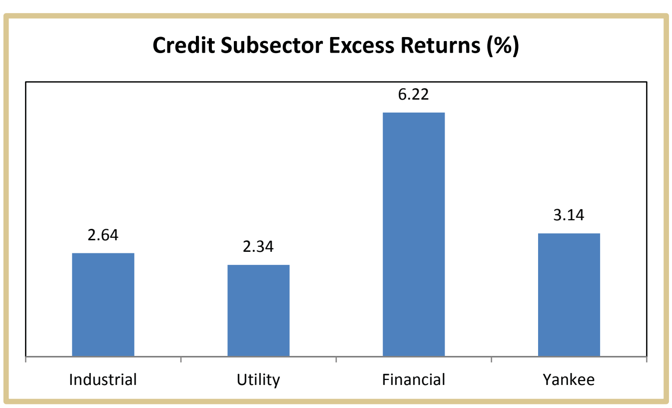
In the first quarter of 2012, the broad fixed income market as measured by the Barclays Capital Aggregate Index generated a total return of 0.3%. Improved U.S. economic data coupled with a better tone in the global markets enabled all major fixed income spread sectors to outperform duration-equivalent Treasuries.

The securitized sector had a strong first quarter, outpacing Treasuries. Secondary markets were active with swap spreads tightening by about 20 bp, while implied swaption volatility declined. Supported by a production coupon bid from the Federal Reserve together with money manager, bank and REIT interest across the coupon stack, the agency mortgage-backed securities (MBS) sector outperformed Treasuries. Higher coupons benefited from their better carry advantage, while the reduction in implied volatility supported lower coupons. The CMBS sector was once again the top performer in the Aggregate Index.



Source: Barclays Capital





Source: Barclays Capital

Lower-rated tranches outperformed their AAA-rated counterparts. Solid demand for short maturity, high-quality assets resulted in excess return for the asset-backed sector (ABS); new issue spreads are now at their post-crisis tights despite a 50% increase in new issue volume relative to a year ago.

The U.S. credit sector posted its best first quarter for any year since at least 1992 as the index's spread tightened by 56 bp. The standout performer was the financial sector as positive results from the Federal Reserve's stress test on banks and financial firms coupled with an easing of the sovereign debt crisis buoyed the financial sector. The industrial and utility sectors also had a strong quarter. Improved investor risk appetite resulted in lower credit-quality issues outperforming higher-quality. Despite the Federal Reserve's Operation Twist program designed to lower longer-maturity interest rates, yields rose 10 to 44 bp across the yield curve with the back end of the curve bearing the brunt of the increase. As a result, the 2-year/30-year yield differential steepened.

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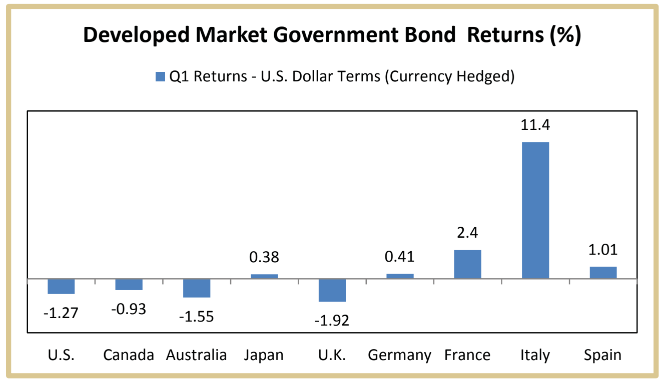
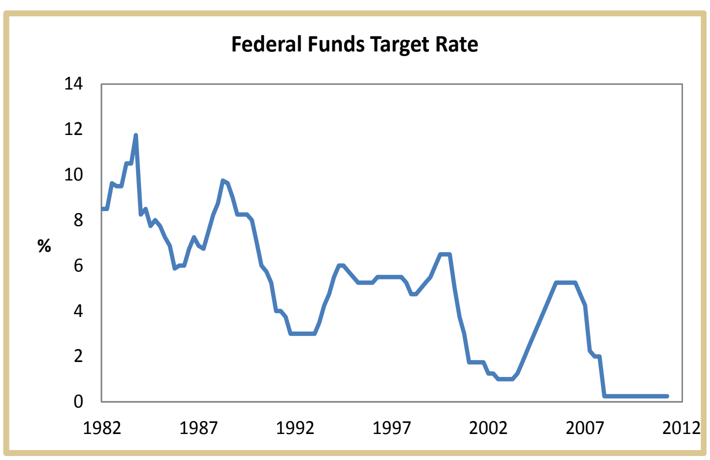
The developed non-dollar bond markets had mixed performance in the first quarter of 2012. Weak economies in Europe and Japan resulted in outperformance of those bond markets versus the U.S. as relative interest rate differentials widened. On the other hand, Australia and New Zealand underperformed as yields in those countries rose by more than in the U.S. on the heels of stronger growth prospects. The U.S. dollar declined against almost all major currencies with the dollar index down -1.5% for the quarter. The only major currency to buck the trend was the Japanese yen which declined over 7% against the dollar.



Source: Citigroup - The Yield Book

Outlook

While economic data releases for the U.S. over the past few months have been better than expected, the March employment report, which showed an addition of 120,000 jobs (versus expectations for 200,000+), broke the trend. Over the past 3 months, however, private sector job growth has averaged 200,000 per month. Additionally, the unemployment rate dropped to 8.2% in March, the lowest rate in 3 years. The 14.5 million auto sales rate (on an annualized basis) in the first quarter of 2012 is 1 million units above the pace in the last quarter of 2011. Consumer confidence and housing data have also improved. However, there are risks to the global markets. These include the on-going European sovereign debt crisis, the rising tension in the Middle East related to Iran's nuclear weapons ambitions, and slowing growth in China. On the fiscal front, election year politics in the U.S. are causing uncertainty about how the record budget deficit will be effectively addressed. Although the likelihood of a recession in the U.S. has diminished significantly, the Federal Reserve has reiterated its commitment to keep the interest rate it controls close to zero until late 2014 due to the risk of contagion from Europe, continued weakness in the housing market and a still elevated unemployment rate.



Source: Bureau of Economic Analysis and Federal Reserve

Furthermore, while the Federal Reserve has not ruled out further expansion of its balance sheet through asset purchases if the economic outlook worsens, the recently released FOMC minutes indicate the "bar has been raised" to warrant such action.

While originations have picked up on an increase in refinance activity, net supply is flat. The Federal Reserve's additional sponsorship has tilted the supply/demand balance in favor of MBS. Mortgage prices remain at levels empirically associated with considerable negative convexity. Additionally, while HARP 2.0 could have a modest impact on prepayments, prepayment speeds are benign by historical standards as a large part of the mortgage universe is credit-impaired with limited ability to refinance even as rates linger near historical lows. With the Federal Reserve on extended hold, and the recent FOMC statement re-affirming low rates until late 2014, carry trades remain in vogue. We generally have a positive allocation bias to securitized products in our portfolios, particularly emphasizing CMBS, as our analysis suggests the potential for material capital gains. Also, high-quality, liquid, short-duration consumer ABS provide opportunities for yield enhancement as cash surrogates. In the credit sector, given the magnitude of the spread tightening and still considerable macro uncertainty, we have reduced our risk exposure, especially to the brokers and money center banks as well as to some of the higher-beta industrials. Although earnings estimates are being lowered for non-financials, credit fundamentals are intact and market technicals remain positive; spreads offer incremental carry over Treasuries. Issuer selection, as always remains critical. The European Central Bank's (ECB) second round of its Long Term Refinancing Operation (LTRO) which now totals over $1 trillion, has alleviated immediate fears about a liquidity crisis in the eurozone. However, the crisis in Europe is not over as evidenced by higher yields (and spreads versus German bunds) for both Spanish and Italian bonds. Volatility is, therefore, likely to remain an overhang for the non-dollar markets.

Lastly, we remain underweight Treasuries and Agencies.

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