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Market Review and Outlook
Fourth Quarter 2011

Review

In the fourth quarter of 2011, the broad fixed income market as measured by the Barclays Capital Aggregate Index posted a total return of 1.12%. The negative effects from the continuing European sovereign debt crisis were offset by steadily improving U.S. economic data. All major fixed income spread sectors outperformed duration-equivalent Treasuries.

The securitized sector registered a strong 4th quarter, outpacing Treasuries by +43 bp. A rebound in the agency mortgage-backed sector (MBS) contributed to the outperformance as a narrowing of option-adjusted spreads enabled the MBS sector to beat Treasuries by +24 bp. Higher coupons outperformed their lower coupon counterparts by +36 bp as carry estimates were adjusted to reflect a more modest negative impact from the announced changes to the government's Home Affordable Refinance Program (HARP 2.0). Supportive market technicals, low new issuance, and stabilizing fundamentals helped the commercial mortgage-backed sector (CMBS) shrug off the European debt crisis. For the quarter, the CMBS sector was the best fixed income spread sector earning +249 bp over Treasuries. Lower-rated tranches led the way, outpacing their AAA-rated counterparts by more than +169 bp as liquidity in the secondary market returned. Despite strong demand, the asset-backed sector (ABS) lagged duration-equivalent Treasuries by -28 bp as swap spreads widened by 8 to 13 bp. Improved investor sentiment helped the U.S. credit sector rebound from a disappointing 3rd quarter resulting in an outperformance of duration-neutral Treasuries by +61 bp. The industrials and utilities sectors posted +112 and +95 bp of outperformance respectively. The finance sector's relative performance was a more muted +29 bp as the European sovereign debt crisis continued to weigh on financials. Credit quality performance mirrored the improved risk-appetite environment with the AA-rated sector posting +19 bp of excess return, while the BBB and high yield sectors outperformed by +157 and +569 bp respectively. Despite the strong performance for risk assets in the fourth quarter, Treasury yields remained near record lows, a sign of investors' nervousness coupled with the Federal Reserve's continued accommodative monetary policy. Five-year Treasury yields closed the year at 0.8%, while the 10-year yield ended at 1.9%. For the quarter, the yield curve (as measured by the 2-year/30-year Treasury yield differential) flattened by 2 bp to 265 bp.

While the U.S. economy was showing signs of a modest recovery in the latter part of 2011, expectations in Europe were deteriorating. As a result, most non-dollar bond markets in the developed regions outperformed the U.S. across the yield curve in the last quarter of 2011. Signs pointing to a widening global economic slowdown prompted central banks such as the European Central Bank and the Reserve Bank of Australia to cut interest rates by 50 bp during the quarter. The Australian, New Zealand, German and United Kingdom government bond markets outperformed the U.S. by 25 to 60 bp. The turmoil in Europe thwarted a mid-year recovery in the euro resulting in its decline of over 3% versus the U.S. dollar. In contrast, both the Australian and New Zealand dollar gained 5.5% and 2.1%, respectively.

Outlook

Economic data releases for the U.S. are increasingly pointing to signs of a self-sustaining economic recovery. The monthly employment reports show that job gains have been averaging 137,000 in 2011, almost double the monthly gains in 2010. For the full year, employers added over 1.6 million workers, the most since 2006. Household employment has been even stronger, averaging 228,000 per month over the past three months, while the unemployment rate has dropped to 8.5%. In December, vehicle sales were at a 13.5 million annual rate, 7.6% higher than a year ago. Manufacturing and service sector surveys also indicate expansion. However, the U.S. economy faces headwinds that continue to be a source of concern and volatility. The widening European sovereign debt crisis is now firmly on center stage, heightening investor nervousness and market volatility. Consequently, the likelihood of a recession in Europe has now appreciably increased. Emerging market economies such as China and India are slowing in response to the weakness in Europe as well as monetary policy tightening to combat inflation in the domestic economies. On the fiscal front, election year politics in the U.S. is 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 for the next two years due to the risk of contagion from Europe, continued weakness in the housing market and a still elevated unemployment rate. Furthermore, the Federal Reserve has not ruled out further expansion of its balance sheet through asset purchases if the economic outlook worsens.

Our relative value framework indicates that agency MBS are cheap. 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, adding to demand from money managers, REITS and banks. 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 at historical lows. With the Fed on extended hold, 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, the high quality and liquidity that short-duration consumer ABS provide as cash surrogates make them attractive. We retain our overweight to the corporate sector. Excluding the peak spreads corporate bonds cheapened to in late 2008/early 2009, credit spreads are now at or near their widest levels. The sovereign debt crisis in the Eurozone has created stresses not only in the European banking system but also in the U.S. money center banks via sovereign exposures. The spread widening in financials may, however, be somewhat over-done as net exposure to sovereign credit is manageable when measured against tangible common equity for the big U.S. money center banks. In non-financials, although earnings estimates are being lowered for companies, credit fundamentals remain intact and spreads are attractive. Issuer selection, as always remains critical. The sovereign debt problems in the peripheral Eurozone regions have intensified and spread to bigger countries such as Italy. The structural nature and complexity of the issues involved present investors and policymakers with challenges. Volatility will remain in both the foreign exchange and debt markets of the Eurozone until an effective long-term solution is put in place. This will weigh on the euro while providing a bid for safe-haven currencies, including the U.S. dollar, despite their unattractive interest rate differentials.

Finally, we remain underweight Treasuries and Agencies.

Returns

Barclays Capital Indices	4Q 2011 Return (%)	4Q 2011 Excess Return (bp)	2011 Return (%)	2011 Excess Return (bp)
Barclays Aggregate Index	1.12	29	7.84	-114
Barclays Intermediate Aggregate	0.91	23	5.97	-79
Barclays Government Credit	1.18	25	8.74	-124
Barclays Int. Gov't Credit	0.84	13	5.80	-67
Treasury Index	0.89	--	9.81	--
Agency	0.55	5	4.82	19
U.S. Credit	1.70	61	8.35	-322
Asset-Backed	0.23	-28	5.14	52
Mortgage-Backed	0.88	24	6.23	-106
Commercial Mortgage-Backed	3.11	249	6.02	47