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Market Review and Outlook
2nd Quarter 2011

Review

In the second quarter of 2011, the fixed income markets as reflected by the Barclays Capital Aggregate Index posted a total return of 2.29%. Weaker economic data coupled with renewed concerns about European sovereign default risk resulted in a flight to quality which pushed Treasury yields sharply lower. Most fixed income spread sectors underperformed duration-equivalent Treasuries for the quarter.

Despite higher volatility, the securitized sector was one of the best spread sector performers with +30 bp of excess return helped in large part by the strong (+36 bp) outperformance of the agency mortgage-backed securities (MBS) sector. In the mortgage sector, carry and spread tightening more than offset losses due to higher implied volatility. Conventionals lagged their GNMA counterparts by -66 bp due to higher FHA mortgage insurance premiums, and the increased supply of conventionals, as the Treasury began unwinding its MBS holdings. Following strong performance over the prior several quarters, the commercial mortgage-backed sector (CMBS) gave back some ground this quarter with an underperformance of -54 bp. In a reversal from previous periods, higher-rated and shorter-maturity tranches outperformed subordinate and longer tranches by more than +150 bp. The asset-backed (ABS) sector fared much better with +16 bp of excess return as investors continue to show a preference for the shorter duration profile of consumer ABS. Heavy new issuance (up 20% year-over-year) and weaker economic data weighed on the credit sector resulting in -7 bp of underperformance. Reduced analysts' earnings estimates, and increased Basel III capital requirements for Systemically Important Financial Institutions (SIFI) along with general risk aversion led to finance sector underperformance of -55 bp. The safe-haven utility sector managed to post +2 bp of excess return, while industrials lost -24 bp. Credit quality performance mirrored investor risk aversion with the A-rated sector underperforming duration-neutral Treasuries by -22 bp, while the high yield sector lagged by -110 bp. In this environment, short-to-intermediate Treasury yields plummeted 30 to 50 bp in the second quarter. In fact, the yield on the 2-year Treasury nearly equaled its all-time low of 0.31% last November. For the quarter, the yield curve (as measured by the 2-yr/30-yr yield differential) steepened +22 bp, closing at 391 bp.

In the non-dollar markets, the second quarter was dominated by the resurfacing of the issues surrounding the European debt crisis, slowing economies and monetary policy tightening in China. As a result, the fixed income markets in the developed countries underperformed the U.S. for the quarter. In Germany, government yields underperformed the U.S. by 10 to 20 bp. The Japanese bond market underperformed across the curve by 20 to 45 bp, while the Australian and New Zealand markets lagged by 10 to 20 bp. Widening interest rate differentials caused the U.S. Dollar Index to fall 0.5% (measured against a basket of six major currencies). The expectation of higher rates in both Europe and Asia provided positive momentum for foreign currencies. New Zealand led the Asian currencies with an 8.9% gain for the quarter, while the

Australian dollar and Japanese yen moving up 3.8% and 3.2% respectively. The euro was up 2.4% despite the European debt crisis.

Outlook

While the recent weakness in the economy may be attributed to temporary factors such as higher gasoline prices, bad weather and this year's disasters in Japan, the U.S. economy continues to be weighed down by a housing market that remains at recession lows, a stubbornly high unemployment rate above 9%, and bank lending that is only gradually increasing from a low level. These headwinds have resulted in economic growth that is well below potential while helping restrain core inflation. With this backdrop, we continue to believe the Federal Reserve will not begin to raise interest rates until early 2012, at the earliest.

Although MBS look fairly valued, originations remain very light, and strong demand from banks and foreign investors creates a favorable supply/demand technical. Furthermore, with the Federal Reserve on extended hold and generally dwindling outstanding volume, there is 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 suggests that improving fundamentals combined with strong technical underpinnings can provide significant spread compression. Solid fundamentals continue to underpin corporate spread valuations, and we retain our overweight to this sector. Our relative-value framework indicates the finance sector remains attractive vis-à-vis industrials and utilities. In addition, the increased capital buffer for SIFI's is a positive for bondholders, and as such we remain overweight the sector. Issuer selection across all sectors, however, is becoming more critical as an increasing number of companies are shifting their focus from protecting their balance sheets and credit metrics to re-leveraging activities through M&A, share repurchases and increasing dividends.

In the non-dollar markets, the issues surrounding the European debt crisis remain a significant risk as investors begin to focus on the debt maturity schedules of the peripheral Eurozone countries. A continued hawkish stance on monetary policy by the European Central Bank (ECB) further contributes to the risk of an economic slowdown in the region. Interest rate hikes and moderating economic activity in China are likely to slow the pace of growth in Australia and New Zealand. Lastly, we remain underweight Treasuries and Agencies.

Returns

Barclays Capital Indices	2Q 2011 Return (%)	2Q 2011 Excess Return (bp)	Year-To-Date Return (%)	Year-To-Date Excess Return (bp)
Barclays Aggregate Index	2.29	8	2.72	60
Barclays Intermediate Aggregate	2.17	10	2.65	58
Barclays Government Credit	2.32	-3	2.61	40
Barclays Int. Gov Credit	2.12	-3	2.47	31
Treasury Index	2.39	--	2.22	--
Agency	1.60	5	1.90	34
U.S. Credit	2.50	-7	3.41	100
Asset-Backed	1.77	16	2.42	78
Mortgage-Backed	2.28	36	2.87	92
Commercial Mortgage-Backed	1.63	-54	3.71	153