Market Review & Outlook

2nd Quarter 2012

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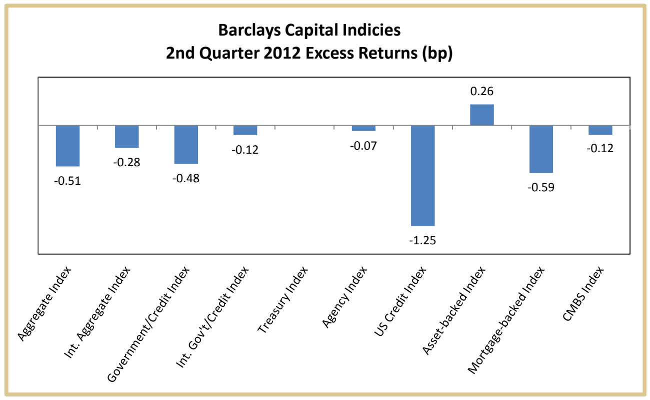
Highlights

- *Economic growth prospects in the U.S. have shifted decidedly lower.*
- *Globally, the economic slowdown is spreading beyond developed markets to emerging countries. Apprehension about the increasing risks in the global markets has led to greater demand for "safe assets".*
- *Although we have increased our defensive posture by reducing spread sector overweights, we still maintain an overall overweight as we continue to see selective opportunities across all fixed income spread sectors.*

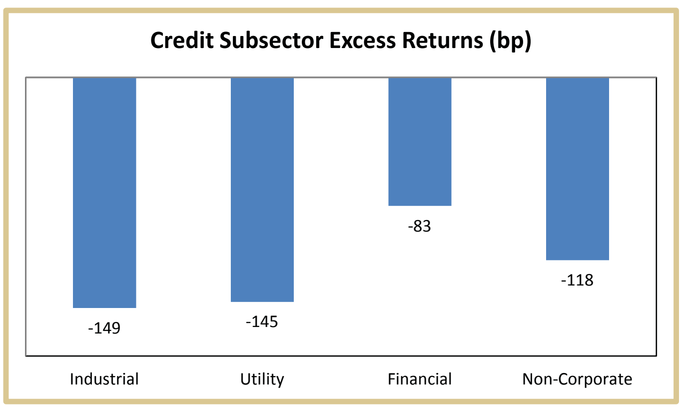
Review

In the second quarter, the broad fixed income market as measured by the Barclays Capital Aggregate Index generated a total return of 2.06% as Treasury yields dropped sharply due to the spreading global economic weakness and escalating Eurozone debt crisis. The resulting investor risk aversion led most major fixed income spread sectors to underperform duration-equivalent Treasuries.

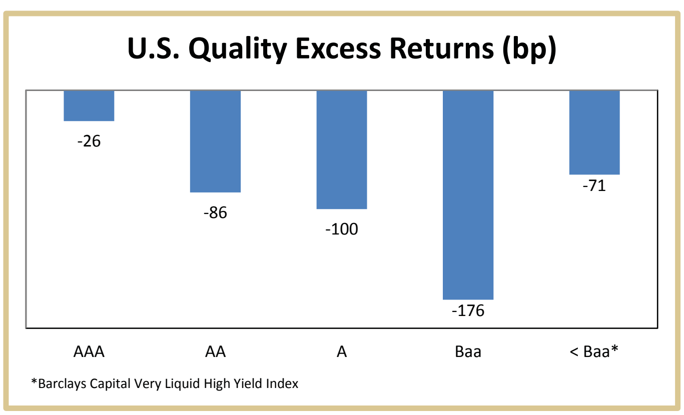
The securitized sector posted -55 bp of excess return driven by the underperformance of the residential mortgage-backed (MBS) sector due to wider spreads and convexity losses. As current coupon mortgage yields moved decisively below 3%, a key refinancing index rebounded to the highs of Fall 2010 which coincided with the last big refinancing wave for Agency mortgages. GNMAs lagged their conventional counterparts as investors expected higher prepayments on GNMA mortgages due to lower FHA premiums on streamlined refinance loans. Despite the heightened macro risks, the commercial mortgage-backed (CMBS) sector held its ground, and only slightly lagged Treasuries.



Source: Barclays Capital



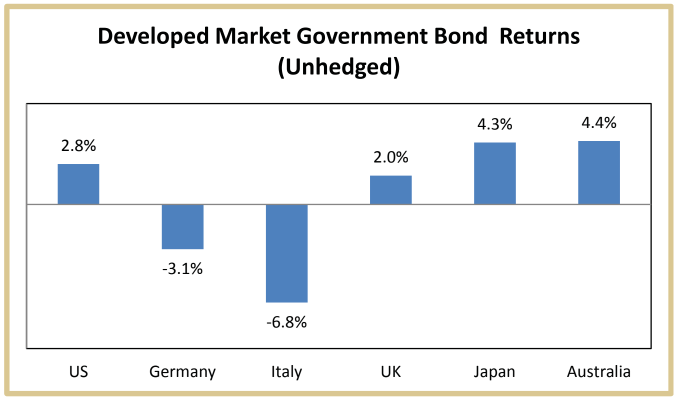
After a strong first quarter, spreads in the credit sector widened on profit-taking and risk-aversion resulting in an underperformance for the sector. While all sub-sectors lagged, the finance sector held up best. The credit curve also steepened as long maturity issues underperformed intermediates.



Source: Barclays Capital

While performance by quality reflected investors risk aversion, the high yield sector atypically held up much better. During the quarter, flight-to-quality drove Treasury yields (especially longer maturities) sharply lower. Ten-year and longer maturity Treasury yields plummeted by more than 50 bp, while 2-year yields declined by just 3 bp. As a result the 2-year/30-year yield curve (differential) narrowed ending the quarter at 245 bp.

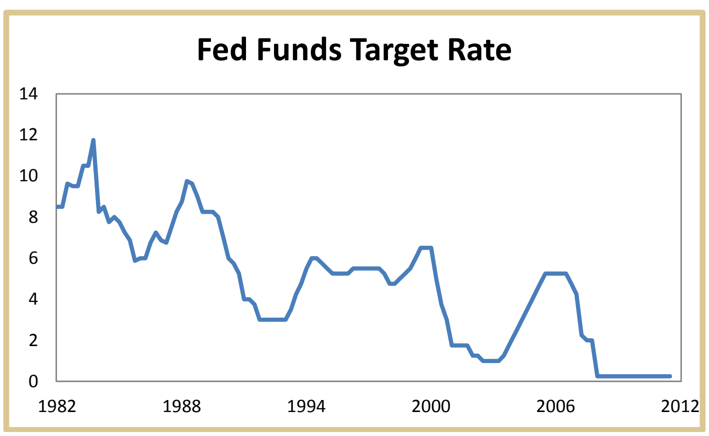
The risk aversion climate caused most developed country bond markets to underperform the U.S., while the U.S. dollar also rallied against other currencies. Interest rate spread differentials for intermediate and long maturities widened for the U.K., Canada, Germany and Japan. Notable exceptions were New Zealand and Australia where yield spread differentials (versus the U.S.) narrowed. The Australian central bank cut interest rates by 75 bp during the second quarter in response to a persistent weakening in home prices, sluggish growth and the slowdown in China, a major trading partner. The U.S. dollar strengthened against the Australian dollar, New Zealand dollar, British pound and Canadian dollar, while it rose a sharp +5.1% versus the euro as the continuing problems in the Eurozone weighed on the region's currency. The only major currency against which the U.S. dollar weakened was the Japanese yen which benefited from investor risk aversion. The yen appreciated by almost 4% against the dollar for the quarter.



Source: Citigroup - The Yield Book

Outlook

Economic growth prospects in the U.S. have shifted decidedly lower. In June, nonfarm payrolls expanded by 80,000 bringing the second quarter average to 75,000, down significantly from the first quarter's pace of 225,000. The unemployment rate remained at an elevated 8.2%. Despite lower gasoline prices, which act like a tax cut for consumers, retail sales in June grew by the slowest pace in 2 years. On a positive note, U.S. vehicle sales in June exceeded consensus expectations, rebounding to 14.1 million (on an annualized basis). Globally, the economic slowdown is spreading beyond developed markets to emerging countries. Manufacturing surveys, both in the U.S. and abroad, have decelerated markedly indicating a slowing global economy. Apprehension about the increasing risks in the global markets has led to greater demand for "safe assets". Investors' concerns include the on-going European sovereign debt crisis, slowing growth in emerging economy powerhouses such as China, India and Brazil, and the tension in the Middle East related to Iran's nuclear weapons ambitions. On the fiscal front, election year politics in the U.S. are causing uncertainty about how the record budget deficit will be effectively addressed, and the consequences of the impending "fiscal cliff". The Federal Reserve lowered its estimate for U.S. economic growth this year by 0.5%, and reiterated its commitment to keep the key federal funds rate close to zero at least through late 2014. In response to the economic slowdown, the Fed extended its program of selling short-dated Treasury securities and buying longer dated issues ("Operation Twist") through the end of this year. Further expansion of the Fed's balance sheet cannot be ruled out if the economic outlook deteriorates further.



Source: Bureau of Economic Analysis and Federal Reserve

While originations have picked up on an increase in refinance activity, net supply is flat. The Federal Reserve's 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 is having 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, selective high-quality carry trades remain in vogue. This is especially true in agency MBS, high quality CMBS and the short-duration, liquid consumer ABS sector which still offers attractive yields as a cash surrogate. In the credit sector, although market technicals remain positive, reduced earnings visibility and the considerable macro uncertainty warrant lower risk exposure heading into the seasonally weak period for credits. We will look to add spread and yield on any material spread widening, though issuer selection will continue to be critical.

While the unexpected concessions by Germany at the recent summit meeting of Eurozone leaders provided a euphoric "risk-on" reaction in the financial markets globally, it may be premature to declare victory. Major hurdles may have to be cleared before the policy responses agreed to in principle at the summit, such as a banking union, are implemented. Some of the agreements may require approval by national parliaments or even treaty amendments. Meanwhile the balancing act between austerity measures to bring fiscal budgets under control and growth programs to alleviate the painful recession in many parts of the region remains a major challenge. There is no quick fix to the crisis in Europe. The road to recovery will be long and bumpy, underpinning safe-haven currencies such as the U.S. dollar and the Japanese yen.

Lastly, while we have increased our defensive posture by selectively reducing spread sector overweights, our portfolios continue to have an overall overweight to spread sectors.

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