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Market Review and Outlook
Third Quarter 2011

Review

In the third quarter of 2011, the broad fixed income market as measured by the Barclays Capital Aggregate Index posted a total return of 3.82%. Weaker economic data coupled with Standard & Poors downgrade of the U.S. long-term sovereign credit rating and increased concerns about European sovereign default risk resulted in a flight-to-quality which drove Treasury yields sharply lower to all-time lows. Consequently, all the major spread sectors underperformed duration-equivalent Treasuries.

The securitized sector posted -228 bp of excess return, its worst quarterly performance since the fourth quarter of 2008; even the agency mortgage-backed sector (MBS) underperformed Treasuries by -221 bp as volatility spiked higher resulting in wider spreads and convexity losses. Higher coupon MBS lagged lower coupons by more than 50 bp due to the sharp drop in Treasury yields and renewed speculation about a government-assisted program that could expand the refinanceable universe by relaxing credit/LTV requirements and lowering fees. Lower and current coupons also benefited from the Federal Reserve's announcement that it would reinvest principal payments from its holdings of agency mortgage-backed securities and agency debt back into agency mortgage-backed securities. Despite stabilizing fundamentals, heightened risk-aversion weighed on the commercial mortgage-backed sector (CMBS) which lagged Treasuries by -352 bp. The CMBS credit curve steepened with AAA-rated tranches outperforming lower rated tranches by over +300 bp. The asset-backed (ABS) sector was the best performer, breaking even relative to duration-neutral Treasuries, as delinquency and loss ratios continued to improve. However, the ABS curve also steepened as longer-dated and lower-quality issues underperformed. The U.S. credit sector underperformed duration-matched Treasuries by -475 bp, as the overall sector's spread widened by 78 bp. The finance sector was especially hit hard, posting -729 bp of excess return, on fears of contagion from the escalating problems in Europe as well as the racheting down of analysts' earnings estimates. Even the industrial and safe-haven utility sectors were negatively impacted in the broad market sell-off, underperforming by -394 bp and -350 bp, respectively. Credit quality performance mirrored investor risk aversion with the AA-rated sector lagging by -344 bp relative to Treasuries, while the BBB and high yield sectors trailed -644 and -1035 bp, respectively. In this extremely risk-averse environment, the 10-year Treasury yield reached an all-time low yield of 1.71%, while the yield on the 30-year Treasury bond approached the lows it made at the end of 2008 during the Great Recession. For the quarter, the yield curve (as measured by the

2-yr/30-yr yield differential) flattened by -124 bp, closing at 267 bp as investors began to discount the Federal Reserve's "Operation Twist" program of selling Treasury securities with maturities of 3 years or less and buying longer-dated Treasuries.

The tumult and volatility in the non-dollar markets were due in no small part to concerns about a slowing world economy together with the deepening and widening European debt crisis. The result of the Federal Reserve's Maturity Extension Program ("Operation Twist") has been one of the primary catalysts in the widespread underperformance of the long end of the non-dollar bond markets. The German, United Kingdom and Japanese 30-year bonds underperformed the U.S. by 25 to 62 bp. In contrast, the short end of the non-dollar markets outperformed the U.S. by 5 to 20 bp. In the currency markets, the U.S. dollar index (measured against a basket of six major currencies) strengthened by 6%. Global recession fears dramatically weakened the New Zealand and Australian dollar by -10.9% and -9.8% respectively versus the U.S. dollar. The euro and the Canadian dollar weakened during the same period by nearly -7% while the British pound ended the month down -4%.

Outlook

Since mid-year, there has been heightened investor angst about a double-dip recession. These fears have been driven by weaker than expected macroeconomic data, political gridlock and the worsening sovereign debt crisis in Europe. While the situation in Europe remains problematic, more recent U.S. economic data releases have been encouraging which should reduce the odds of an impending recession. Besides vehicle sales which have moved above 13 million on an annualized rate after having averaged below 12 million over the past four months, indices for the manufacturing as well as service sectors are above 50 which indicates on-going expansion. Additionally, the September employment report showed unexpected job gains of almost 200,000 when upward revisions to the prior two months are included. Given the depth of the recent recession, economic growth is unlikely to be at the pace seen during past recoveries. As a result, the Federal Reserve has committed to keep the interest rate it controls to close to zero for the next two years. Following its September meeting, the Federal Reserve Open Market Committee (FOMC) acknowledged the significant downside risks to the economic outlook, and conveyed the central bank's decision to extend the average maturity of its holdings to make broader financial conditions more accommodative. In this environment, the steep yield curve is likely to continue its recent flattening trend.

Following the third quarter's significant spread widening, MBS are cheap. Originations have picked up on the increase in refinancing activity; net supply, however, remains negative. Additionally, the supply/demand balance has shifted in favor of MBS as sizeable Federal Reserve buying will add to the demand from money managers, REITs and banks. Although mortgage prices remain at levels empirically associated with considerable negative convexity, the lower market rates for mortgages are likely to result in less refinance response than has been the case historically because a large part of the mortgage universe is credit impaired with limited ability to refinance even with rates at historically low levels. However, a potential government refinancing program is still a risk for the sector. At the same time, with the Fed on extended hold, carry trades are back in vogue. We, therefore, have a positive allocation bias to the securitized sector in our portfolios. We are particularly emphasizing CMBS product, as our analysis still suggests the potential for material capital gains. We retain our overweight to the corporate sector as valuations are now back to levels not seen since October 2009. 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. The banks have significantly repaired their balance sheets over the past 3 years and now have larger capital cushions and less leverage than before the financial crisis. In non-financials, fundamentals remain largely intact and balance sheets are strong. 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

	3Q 2011		Year-To-Date	
Barclays Capital Indices	Return (%)	Excess Return (bp)	Return (%)	Excess Return (bp)
Barclays Aggregate Index	3.82	-202	6.65	-144
Barclays Intermediate Aggregate	2.30	-157	5.01	-102
Barclays Government Credit	4.74	-187	7.47	-149
Barclays Int. Gov't Credit	2.39	-110	4.92	-80
Treasury Index	6.48	--	8.84	--
Agency	2.42	-14	4.36	14
U.S. Credit	3.03	-475	6.54	-383
Asset-Backed	2.42	0	4.90	80
Mortgage-Backed	2.36	-221	5.30	-131
Commercial Mortgage-Backed	-0.86	-352	2.82	-208