



### After the Deluge

As 2Q began, the largest contraction of global economic activity since at least WWII was underway, a deep and painful recession that left virtually no area of the global economy untouched. The contraction followed the near-complete seizure of global financial markets in late 2008 that resulted in the worst annual performance most financial markets had ever seen, at least post-WWII.

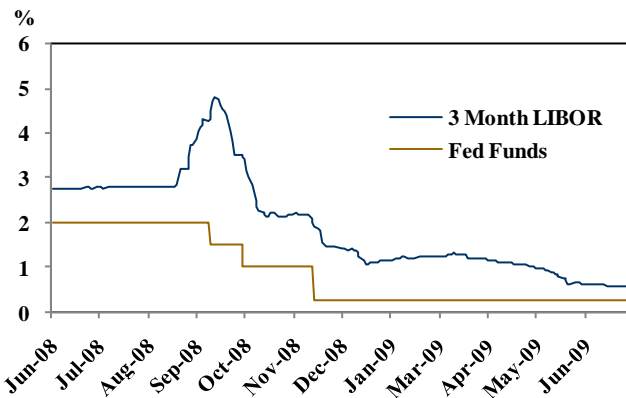
Fortunately, equally comprehensive and ground-breaking efforts to stabilize economies and markets were quickly initiated around the world. For their part, the Federal Reserve and US Treasury implemented an unprecedented range of new programs intended to guarantee, finance, or buy whatever financial assets necessary to steady the US financial system.

#### From Bust to Boom

These government-sponsored programs brought considerable reassurance to the US financial markets during the quarter. The critically important short-term lending market (LIBOR), which had substantially recovered by the end of 1Q, made further progress in 2Q.

#### Interbank Lending Rates Continued to Decline in 2Q, From Last Year's "Panic" Levels

June 30, 2008 – June 30, 2009



Source: Bloomberg as of 6/30/09.

The most dramatic impact of these programs, however, was seen in the US credit markets. With spreads at exceptionally attractive levels and government programs providing support, tentative signs in 2Q that the global economy might be bottoming were enough to trigger a groundswell of flows – both institutional and retail -- into US "spread product", including investment grade and

high yield corporate bonds, emerging markets debt, municipal bonds, and structured product.

The result? After turning in their worst post-WWII performances on record in 2008, most fixed income sectors racked up unprecedented positive excess returns over US Treasuries in the first half of 2009, with most of that return coming in 2Q.

#### Credit Markets Make a Comeback

Fixed Income Performance by Market Sector  
As of June 30, 2009

Excess Returns vs. US Treasuries	2Q 2009	YTD 2009
<b>US Aggregate</b>	+ 365 bps	+ 430 bps
<b>Mtg-Backed Securities (Agency MBS)</b>	+ 123	+ 297
<b>US Corporate Bonds</b>	+ 1,361	+ 1,314
<b>Commercial Mtg-Backed Securities</b>	+ 2,849	+ 2,563
<b>Asset-Backed Securities</b>	+ 875	+ 1,699
<b>Emerging Markets Debt</b>	+ 1,615	+ 2,233
<b>US High Yield</b>	+ 2,518	+ 3,291

Source: Barclays Capital. Indicates the performance of a representative index for each sector listed in the table.

The spectacular returns in the ABS and CMBS markets were largely attributed to the new TALF programs that promised to bring attractive Fed-sponsored financing to these sectors. Returns in the corporate bond market, particularly from banks and other financial issues, were helped by the fact that many of the 19 US financial institutions that the US Government had stress-tested earlier in 2Q were able to raise equity and debt without the need for government guarantees, which not only bolstered their capital positions, but also demonstrated their ability to successfully access the markets. Many banks, in fact, returned the TARP funds they had received earlier, signaling the end of creeping bank nationalization.

While the spread sectors enjoyed a downright terrific 2Q, the opposite was true for US Treasuries. In contrast to the Fed's successful Agency debenture and mortgage pass-through buy programs, the Fed's Treasury buy program proved ineffectually small. With the Fed's Treasury purchases not nearly enough to offset heavy supply and concerns over economic recovery and potential inflation, US Treasury yields generally rose over 2Q.

#### The Economy: Just How Good is "Less Worse"?

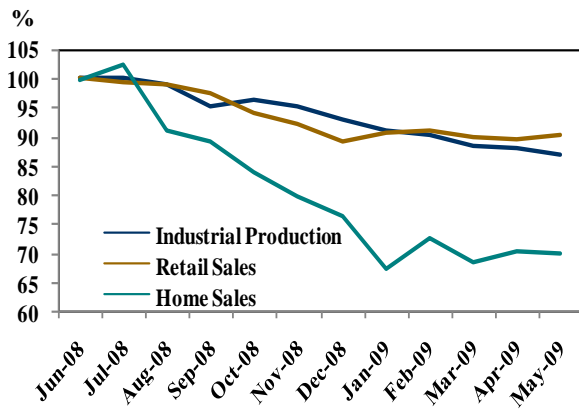
As satisfying as the returns in the credit markets were in 2Q, it is noteworthy that they were achieved despite an economic backdrop that remains, by all accounts, fragile.

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## Are These Green Shoots?

June 30, 2008 – May 31, 2009



Source: Bloomberg as of 5/31/09.

While the actual level of growth during 2Q remained weak, many leading indicators turned positive over 2Q, or, at a minimum, “less negative”. Extrapolating the leading indicators into the future, we believe economic growth should resume sometime in 2H '09. However, the high hurdles of still-declining employment, rising energy prices, an ongoing residential real estate slump, and

***Conclusion: Near-term, spread markets vulnerable to a correction. Longer-term, we continue to be optimistic, emphasizing well-researched credit and structured product opportunities.***

## US GOVERNMENTS

US Treasury bonds lagged all other US fixed income sectors in 2Q as interest rates rose across the yield curve. Ten-year US Treasury yields rose by +87 bps, to 3.54%, while 30-year yields rose +80 bps, to 4.33%. Ten-year US Treasury yields are now +130 bps higher than at year-end 2008. Volatility rose steadily throughout 2Q, primarily due to record amounts of new US Treasury issuance required to finance the government's myriad stimulus packages. To offset this supply, the Fed began implementing a Treasury buyback program this spring. However, the volume of buybacks was simply not enough to offset sharply higher supply, combined with reduced demand from foreign central banks that had been steady buyers of US Treasuries with their reserves. Given the significant rise in rates and increase in inflation expectations to more normal levels, we believe 10-year Treasuries will find support at the 4.0% level.

Government Agency yields also rose in 2Q, but were generally supported by the Fed's Agency buyback program, moderate supply, and steady investor demand. Agencies delivered +132 bps in excess return over US Treasuries in 2Q.

The Fed's purchase of nearly \$100 billion of Agency debentures in 2Q, and commitment to purchase \$100 billion more, is providing a level of support. Even so, we hold a marginally negative outlook for the sector as it appears to be fully valued. We also hold a neutral view on Treasury Liquidity Guarantee Program (TLGP) debt, which continues to track agency pricing despite being less liquid than typical government agencies.

*Outlook: Neutral on Treasuries, but will look to add duration at 4.0% 10-year yields. Negative on Agencies given tight spreads to similar maturity US Treasuries.*

## MORTGAGES

Mortgage-backed securities delivered solid results in 2Q with a +123 bps excess return vs. US Treasuries. Mortgages continued to benefit from Federal Reserve and Treasury programs to purchase Agency mortgage securities, as well as from new origination levels that were below expectations.

Although Agency mortgages were stable for most of 2Q, the increase in US Treasury rates caused a commensurate rise in homeowner mortgage rates, which sharply increased hedging costs as mortgage durations extended. Actual prepayments, however, have thus far been anemic, considering record low mortgage rates in most of 2Q. Tight credit conditions, weaker housing fundamentals and

recently higher mortgage rates mean that economic recovery is far from assured.

## Could See Some Consolidation as the Economy Catches Up to the Markets

We are entering the typically illiquid and volatile summer with the credit markets having improved far more than the US economy. While it is possible that these markets could continue to outpace the economy during 3Q as well, the odds are against it. More likely, the markets could see some consolidation, as they wait for economic progress to catch up to the progress already reflected in market prices.

We nonetheless remain positive on spread product longer-term. While spreads in many fixed income sectors are not as wide as they were a quarter ago, they remain wider than historical averages. Furthermore, economic data should continue to improve, if only gradually, over the balance of the year. With record amounts of money earning little interest in money market funds, flows into the fixed income credit and spread markets should remain strongly positive.

understaffing at mortgage lenders pose real hurdles for homeowners trying to refinance.

We hold a negative bias on mortgage securities. Valuations are rich on both a nominal and option-adjusted basis. Volatility has risen considerably: as investors realize that full scale refinancings are unlikely, mortgage durations are extending. Given that the Fed has completed nearly half of its mortgage purchase

program, any change in those plans may likely cause mortgage spreads to widen. In this climate, we continue to prefer 30-year fixed rate mortgages, particularly seasoned loans that have limited extension risk. Higher coupons should perform well given reduced prepayment expectations.

*Outlook: Negative. Mortgage valuations are rich, and market volatility and hedging costs remains high.*

## STRUCTURED PRODUCT

Structured product improved in 2Q, encouraged by the US Government's TALF and proposed PPIP programs, which focus on different types of structured product in an effort to revive lending.

AAA-rated CMBS rallied strongly, with spreads nearly 250 bps tighter over 2Q. However, fundamentals remain challenging. Commercial property values have declined roughly 30% from peak levels, vacancies are rising, and rents are declining. CMBS loan origination remains a small fraction of peak volume, although TALF may help spur origination. Nevertheless, we continue to see value in well-researched, intermediate-term super-senior bonds that are well-protected due to structural enhancements, and are trading at wide spread levels over swaps (+ 500 bps to +700 bps.)

In the non-agency mortgage market, prices improved along with investor risk appetite. Even so, there was

little actual demand other than from opportunity and hedge funds looking to buy at distressed prices. Although fundamentals remain weak and new origination is negligible, prices are at such distressed levels we believe these securities offer significant value long term.

High quality consumer ABS, notably AAA-rated credit card trusts, performed well, with TALF providing support for new issues. Underlying credit card performance, however, continued to soften, with charge-offs rising to 10% on average. To mitigate this weakness, issuers took concrete steps to enhance the quality of their master trusts and manage credit card terms. Auto ABS also held up in 2Q despite slightly higher loan defaults. We believe both AAA credit card and auto securities from top tier issuers offer attractive risk-adjusted returns.

*Outlook: Very positive. TALF and PPIP should generate positive momentum for CMBS and RMBS.*

## US AND EUROPEAN CORPORATE BONDS

US investment grade corporate bonds rebounded in 2Q, delivering a +1,361 bps excess return over US Treasuries as sentiment improved across the credit markets. US corporate spreads narrowed 237 bps during 2Q to close at +306 bps over Treasuries. European corporate spreads narrowed by 162 bps. Corporate bond yields are now at their lowest levels since before the collapse of Lehman Brothers in September 2008.

Sentiment improved on several fronts. Investors were encouraged by signs that Government stimulus efforts were indeed easing the credit crisis. Earnings reports, though weak overall, were better than expected across a number of industries, including the financial industry. Capital positions of the largest banks improved, boosted by substantial equity issuance. Finally, corporate management continued to take aggressive steps to shore up balance sheets, reducing debt and capital expenditures to preserve cash flow.

New issuance rose sharply in both US and Europe, with many new deals oversubscribed two or three times. We expect demand to remain healthy in 3Q as investors continue shifting assets to higher yielding instruments

and companies prepare to meet the requirements of the Pension Protection Act.

Despite this more positive tone, fundamentals remain weak, and ratings agencies continue to aggressively downgrade issuers. We will be closely watching upcoming quarterly earnings reports and economic releases for signs the global recession has begun to turn the corner.

Though cautious overall, we are prepared to increase risk as market conditions and fundamentals improve. Already, we have selectively increased holdings in money center banks and insurance companies based on the more encouraging earnings outlooks and Government support. We remain overweight in defensive sectors, such as pharmaceuticals, healthcare, food and beverage, and are cautious on real estate, consumer-discretionary, and deep cyclical companies. We continue to take advantage of new issue concessions, which result in yields 10 bps to 60 bps higher than similar offerings in the secondary market.

*Outlook: Positive. Stabilizing credit fundamentals, improving liquidity, and strong technicals should drive spreads tighter over the long term.*

## LEVERAGED FINANCE



High yield bonds surged in 2Q, delivering a +2,518 bps excess return to US Treasuries. Year-to-date, high yield bonds are up +30.4% in total return, spurred by improving liquidity and increased investor risk appetite. High yield spreads over similar maturity US Treasuries tightened to +1,025 bps, down from a cyclical high of +1925 bps last December. US and European bank loans also rallied sharply, delivering returns of +34.6% and +23.6%, respectively, so far this year.

Performance varied by credit quality and industry, with lower quality, CCC-rated bonds in the most distressed industries – gaming, media, technology, retails, autos, and homebuilders – performing best. Robust issuance was met by equally strong demand, with new proceeds used to pay down or refinance outstanding debt, improving the liquidity profiles of issuers.

Near term, we hold a cautious stance given still-weak fundamentals and uncertain economic growth prospects.

While many issuers are generating free cash flow, reducing debt, and managing liquidity, others remain over-leveraged. This could keep high yield defaults elevated for the next year or two. Already, the annual default rate has risen to 10% and could climb to up to 15% by year-end.

Considering the sharp compression in spreads, rise in defaults, and economic uncertainty, we believe high yield is approaching fair value at current levels. If the economy remains sluggish, lower quality credits may be at risk for a setback. We continue to focus on higher quality credits with solid asset coverage that should avoid default. We are also finding value in select new issuers, cross-over credits, short-term bonds that may be refinanced, and bank loans.

*Outlook: Cautious overall, emphasizing more defensive opportunities. Favorable technicals are being met with challenging fundamentals near-term. We expect spreads of higher quality high yield credits to stabilize at current levels. Credit selection remains critical.*

## EMERGING MARKETS DEBT



Emerging markets debt benefited from the broad-based recovery in “riskier” assets in 2Q, with the major emerging market indices recouping nearly all of their losses from 2008. Sovereign USD-denominated debt delivered a +11.3% return in 2Q and is up +15.6% year-to-date, while emerging markets corporate debt returned +16.2% in 2Q and +23.9% so far this year. Local debt (hedged to USD) has lagged USD-denominated bonds, rising just 2.7% through 2Q.

As with US high yield, the best performing countries this year were among the worst performers in late 2008. Ukraine, Ecuador, Iraq, Dominican Republic, and Pakistan have risen from 50% to 85%, while Argentina, Venezuela, and Dominican Republic are up around 40%. Despite their sensitivity to the global economy, many higher quality emerging market countries have stronger financial positions than the average developed country, which should lend support overall. Asia, in particular, appears likely to lead the recovery, supported by renewed growth prospects in China and strong

countercyclical stimulus measures. Latin America also appears well positioned despite negative ratings outlooks for Mexico and Venezuela. Conversely, we expect growth in Eastern Europe to be negative, weighed down by bank deleveraging, credit contractions, and rising inflation.

In 3Q, we will be closely watching global growth prospects and investor risk appetite for opportunities to increase risk positions. Currently, we see value in select hard currency bonds priced at distressed levels (Venezuela, Argentina, Indonesia), and select quasi-sovereign corporate bonds (Gazprom and TNK, Russian oil companies, and China Fisheries.) Local bonds in countries whose central banks have the flexibility to reduce rates, such as Brazil, Mexico, and Turkey, may provide opportunities. Emerging markets FX may also provide opportunities, but we are generally not optimistic given declining global trade.

*Outlook: Cautious overall, with a focus on select opportunities. Key risks include a prolonged global economic slowdown and a sudden decrease in investor risk appetite.*