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Market Review and Outlook February, 2010

Review

In February, fixed income total returns for the broad market, as measured by the Barclays Capital Aggregate Index, amounted to a “coupon-clip” month of 0.37%. The non-Treasury sectors posted mixed performance with excess returns versus duration-equivalent Treasuries ranging from -7 bp to +144 bp. While the securitized sector outperformed Treasuries by +5 bp, there was great dispersion within the sub-components. The commercial mortgage-backed (CMBS) sector, despite rising delinquencies and defaults, was a stellar performer outpacing Treasuries by +144 bp. On the other hand, the announcement of delinquent-loan buyouts by Fannie Mae and Freddie Mac weighed heavily on the residential mortgage-backed sector (MBS) which underperformed by -7 bp. Better clarity regarding the timing and scope of the buyouts by Freddie Mac resulted in the Freddie Mac pass-through sector outperforming the Fannie Mae sector by +29 bp. The asset-backed (ABS) sector generated +17 bp of excess return as spreads tightened in response to strong demand for the sector’s high-quality securities. Increased concerns over sovereign credit risk, particularly Greece, coupled with uncertainty about proposed financial reform legislation coming out of Washington, stalled the rally in the credit sector which posted only +1 bp of excess return. Agency debentures gained +21 bp relative to duration-equivalent Treasuries as investors continued to search for high-quality yield, and new issuance has been muted relative to expectations. Movements in Treasury yields were fairly benign; the 2-year yield closed the month unchanged at 0.8% while the yield on the 30-year Treasury bond rose 7 bp to 4.56%, resulting in a steepening in the yield curve to 375 bp. For the month, the Treasury sector generated 0.4% of total return. Performance in government bond markets in most developed countries was mixed. A notable feature in February was the steepening of yield curves in some markets. For example, the 2-year/10-year yield differential widened by 43 bp in the U.K., and by 45 bp in New Zealand. While contagion concerns and political uncertainty led to the steepening in the U.K., weaker-than-expected economic data contributed to the steepening in New Zealand. In other regions, yields rose in Australia and Canada, on evidence of stronger economic recoveries. In the foreign exchange markets, the U.S. dollar index (measured against a basket of six major currencies) gained 1% primarily due to the problems in Europe. The British pound fell 4.5%, while the euro declined by 1.5% against the U.S. dollar. The Japanese yen, on the other hand, gained 1.5% on the continued reversal of carry-trades.

Outlook

U.S. GDP growth in the last quarter of 2009 was revised slightly higher to 5.9% primarily due to a slower inventory depletion rate. Although growth in the first quarter of 2010 is likely to be adversely impacted by the severe weather experienced in much of the country, the

underpinnings of the recovery remain firm. Strong corporate profits are fueling a resurgence in capital expenditures spending; capex in the fourth quarter of 2009 was up 18.2%. While the housing sector remains weak, with January existing home sales at the lowest rate since June 2009, and the pace of new home sales at a record low, the manufacturing sector remains in an expansionary phase. The February reading for the Institute for Supply Management (ISM) was near its highest level in five years. The forward looking new orders component mirrored the overall index, while the employment index showed further improvement. Reflecting the synchronized global economic recovery underway, manufacturing indices in both developing and emerging regions around the world are also showing strength. Meanwhile the service sector report for the U.S. (non-manufacturing) expanded at the fastest pace since October 2007. This indicates the economic recovery is broadening, as the service sector has so far lagged the overall rebound. Additionally, retailers reported a 4.1% year-over-year increase in same store sales in February. Although non-farm payrolls shed 36,000 workers in February, there were some positive indications from the report; net revisions to prior months added 35,000 workers, the unemployment rate held steady at 9.7% and temporary workers increased by another 32K-- all in the midst of severe weather. The minutes from the Federal Reserve's January FOMC meeting signaled a slightly more positive tone; the central bank's projected range for 2010 real GDP was raised to 2.8-3.5% from 2.5-3.5%. The minutes also indicated that downside risks were judged to have "diminished a bit further." Our view is that monetary policy will not be tightened until, at least, late in 2010. The Federal Reserve will want to assess the impact the winding down/expiration of the extraordinary 2008/2009 stimulative measures will have on the financial markets as well as evaluate the condition of the still-challenged labor market.

The Federal Reserve's MBS purchase program is scheduled to expire on March 31st. However, with the GSE's buyout announcements, the technical prospects for the MBS sector have changed. We currently remain underweight the sector but will be opportunistic buyers as we expect excellent values in the higher coupons to materialize once the buyouts are complete. The sector is also likely to benefit as higher paydowns over the next several months result in increased reinvestment demand. Despite fundamental strains in the performance of the ABS and CMBS sectors' underlying collateral, valuations in the higher quality tiers remain compelling. We, therefore maintain our overweight to these two sectors. In the credit sector, we maintain a modest overweight as spreads are still attractive from a historical perspective. Additionally, the positive bias in company earnings and strong technical factors (lighter than expected issuance combined with cash inflows into bond funds) should provide a healthy bid for corporate bonds. The U.S. dollar is likely to remain well-supported due to stronger economic growth in the U.S. relative to Europe and Japan. Commodity-levered currencies like the Australian and Canadian dollar should also find support from the prospects of a recovery in global growth. Lastly, the portfolios remain underweight in Treasuries and Agencies relative to their benchmarks.