

Market Review

Economic data and market activity began showing signs of a recovery in the second quarter. Growth is expected to turn positive in the second half of 2009, with a boost from the restocking of inventories that were drawn down considerably in the first half of the year. Weakness continues in the housing and labor markets, but consumer confidence and spending stabilized and began to turn higher. Many of these increases will likely be short lived, however, because they were spurred by one-time stimulus payments.

The Federal Open Market Committee (FOMC) held rates at a range of 0% to 0.25% and remained supportive of all methods to improve liquidity and access to credit. The FOMC did not make any changes to the quantitative easing programs it initiated in the first quarter. It anticipates that economic conditions will warrant exceptionally low levels of the federal funds rate for an extended period.

Capital markets stabilized in the second quarter, as the economic outlook and liquidity improved. The Barclays Capital U.S. Aggregate Index outperformed duration-adjusted Treasuries by 365 basis points (bps) in the second quarter and had an absolute return of 1.78%. Investors' risk appetites increased as liquidity and the outlook for the economy improved. This, coupled with the record supply of U.S. Treasuries, led to an increase in interest rates and a -3.02% second quarter return for Treasuries. The 10-year Treasury note increased by 87 bps to end the quarter at 3.53%, while the two-year note increased 31 bps to end the quarter at 1.11%.

As investors' risk appetites increased, spreads across all asset classes tightened, leading to positive returns relative to U.S. Treasuries. The best-performing asset classes in the second quarter relative to duration-adjusted Treasuries were high yield corporate bonds, at 25.18%; commercial mortgage-backed securities, at 14.01%; investment grade corporate bonds, at 11.87%; and asset-backed securities, at 8.75%. This compares to less risky asset classes such as U.S. agencies and U.S. mortgage-backed securities, which outperformed by only 1.32% and 1.23%, respectively.

Market Outlook and Strategy

Second-quarter GDP is expected to remain negative, because the economy only just began to stabilize in the second quarter. The positive effects of inventory restocking, stimulus plans and greater access to credit should lead to improved economic growth later this year. Until then, consumer spending will weaken, as wage growth remains at historic lows and consumers shift from borrowing to saving. In addition, the FOMC continues to create a supportive environment to provide liquidity and extend further access to capital. We believe this will provide the basis for positive GDP growth later this year. The yield curve should remain steep, as the front end will remain low with the federal funds rate, while record Treasury issuance will keep the long end from rallying much further.

We are unlikely to see a repeat of the second-quarter's dramatic outperformance of corporate and securitized bonds. We expect some profit taking by portfolios that participated in the strong returns during the second quarter. Given current spread levels, demand for all qualities of corporate bonds and a manageable new issue calendar, however, we believe that investment grade and high yield corporate bonds will continue to generate excess returns versus Treasuries. Securitized asset classes will continue to benefit from government-sponsored programs but to a much lesser extent than in the second quarter.

We believe that fixed income is an attractive asset class: It can protect investors against volatility during a potential downturn in the economy, while it provides strong potential returns, with spreads at historically attractive levels. We believe that security selection and asset allocation will remain the two key drivers of returns in this environment. We expect modest spread widening at various periods in the third quarter, but we will remain overweight to spread product, because we believe most asset classes will outperform Treasuries.