

Market Review

The U.S. has benefited heavily from fiscal and monetary stimulus as well as inventory rebuilding in the first quarter of 2010. We expect slower growth in the second half, however, as the impact of fiscal and monetary stimulus fades and small businesses and households suffer from lack of credit availability.

The capital markets have continued to improve, as risk appetites have increased with signs of a sustained economic recovery. U.S. Treasury yields remained relatively unchanged in the first quarter, as the Federal Open Markets Committee reiterated intentions to keep the target rate low for an extended period. The rate remains at 0 to 0.25%, but the Fed has increased the discount rate to 0.50% and allowed various financial simulative programs to expire in an effort to drain excess liquidity from the system.

The 10-year Treasury rate was lower by one basis point (bp) to close the quarter at 3.83%. The spread between 10-year and 2-year Treasuries ended the quarter about 10 bps steeper at 280 bps. The Barclays Capital U.S. Aggregated Index outperformed duration-adjusted treasuries by 78 bps in the first quarter, with 57 bps of the outperformance coming in March.

Continued strong signs of a sustained economic recovery, stimulative policies and an increased risk appetite from investors led to further tightening of spread assets in the first quarter: U.S. investment grade corporate bonds tightened 22 bps; U.S. mortgage-backed securities (MBS), asset-backed securities (ABS), and commercial mortgage-backed securities (CMBS) tightened by 13, 28 and 138 bps, respectively, and U.S. high yield corporate bonds tightened by 48 bps.

The best-performing asset classes vs. duration-adjusted Treasuries were CMBS (+ 782 bps), high yield (+ 350 bps), and ABS (+ 133 bps). Investment grade also performed well at +113 bps, and MBS trailed most other spread assets classes at +69 bps.

Market Outlook

We believe technical conditions and investor sentiment will remain firm and keep the tone of the marketplace positive. We expect this environment to continue contributing to positive excess returns for investment grade, high yield and other non-government, fixed income securities.

The yield curve is likely to flatten, and rates are likely to increase as the markets anticipate monetary policy tightening in late 2010. Heavy Treasury issuance and a sustained economic recovery without the Fed buying will force yields higher. While we expect long-term rates to rise, we anticipate that they will be constrained by moderate inflation expectations and demand from long-duration investors.

Corporate fundamentals have improved as a result of the economic recovery, cost-cutting efforts and improved access to capital. Companies' renewed access to the capital markets had allowed them to retire debt and issue equity capital to reduce leverage and repair balance sheets. Significant cost-cutting efforts have positioned corporate earnings to benefit from top-line revenue growth.

While fundamentals should remain weak across securitized assets classes, valuations should more than compensate investors for the risk in areas such as CMBS and non-agency residential mortgage-backed securities.

Demand has remained very strong for all non-government-related asset classes. As interest rates remained low and spreads tightened, investors have continued to put more cash to work in this area. We believe demand will continue and contribute further to the positive technicals in the market as the economy recovers.

We continue to see opportunities to profit from tighter spreads in credit and securitized markets, but we expect returns to increasingly be driven by security selection and industry allocation as opposed to broad systematic market movements.