

Market Review

The high yield market continued its string of positive returns that began in early 2009, with March of 2010 marking the 13th consecutive month of positive return. Despite having the lowest quarterly return since 2009, the Barclays Capital Global High Yield Constrained USD Hedged Index managed to return 5.28% in the first quarter. The majority of the quarter's return – 3.4% – was recorded in March. January and February returned 1.6% and 0.2%, respectively.

Global high yield corporate spreads, at 682 basis points (bps) at year end, widened to 741 bps in February, before compressing to 617 bps by the end of the first quarter, the lowest level since the beginning of 2008. Current spread levels remain attractive compared to long-term averages. Most notably, U.S. BB and B spreads are still 70 bps and 30 bps wider than their 17-year historical averages, while CCC spreads are roughly 160 bps inside of their historical average.

March saw a record amount of new issuance, with \$35 billion priced during the month. With \$15 billion and \$13 billion issued in January and February, the year-to-date total is over \$64 billion, more than 40% of the total for 2009.

As we saw in previous quarters, higher-quality bonds (BB and B) dominated the new issuance market, making up 86% in the first quarter. According to Barclays Capital, 25% of the first quarter's new issuance will be used to finance acquisitions, signaling a pickup in M&A activities. Refinancing activity fell from 78% in the first two months to 49% in March. The primary market will likely remain robust throughout the year, with \$163 billion of high yield debt needing to be refinanced in 2010, according to J.P. Morgan.

On the demand side, the high yield market absorbed \$3 billion in the first quarter, according to AMG Data Services. If the current pace continues throughout the year, 2010 will record less than half of the \$33 billion net flows of 2009. Recently, the number of investment grade managers coming into the high yield market for BB short-duration bonds has increased, keeping up the demand for higher-quality high yield bonds.

In the first quarter of 2010, we saw a slight revision in the flight-to-risk trade that dominated 2009. A barbell quality trade occurred in the first quarter. CCC credits have continued their outperformance so far in 2010, but BB credits actually outperformed B credits. We believe this is due to both the increased demand from investment grade managers and a rally in the overall risk appetite for financial paper, which is largely rated BB. Year to date, BBs, Bs and CCCs returned 5.1%, 3.9% and 6.3%, respectively.

Financials contributed the most to the high yield index return. The financial credits in the Global High Yield Constrained Index returned 14% for the first quarter. One of its subsectors, life insurance, returned a staggering 20% for the quarter. Much of the outperformance can be traced to AIG, whose price spiked when the company agreed to sell its Asian life insurance business to Prudential for \$35 billion. Consumer cyclicals also outperformed, with gaming, consumer cyclical services and restaurants returning more than 5% for the quarter. Positive economic data from the Institute for Supply Management, consumer spending and jobs reports also propelled the market. Electric, down 0.87%, was the only sector reporting negative returns for the quarter.

The Moody's Investor Service global issuer-weighted default rate reached 11.57% at the end of February, down from the November 2009 peak of 13.49%. According to J.P. Morgan, default activity slowed significantly in 2010. Only 16 issuers defaulted in the quarter, with a volume of \$5.8 billion in bonds and loans, compared to 118 issuers at \$184 billion in all of 2009. We expect default rates to continue decreasing as liquidity improves and bond issuers are able to negotiate for maturity extensions and covenant amendments. Moody's currently forecasts that the default rate will decline to 2.66% by the end of February 2011. Recovery rates returned to around 40% in 2010, which is in line with the historical level and up from the 2009 level of under 30%.

Following a year with a record volume of fallen angels, at \$150 billion, 2010 has seen a positive credit trend. Year to date, rising stars outpaced fallen angels at 5 to 3 and \$6.1 billion to \$3.5 billion.

Outlook and strategy

We continue to recommend a moderate overweight to high yield bonds, given our positive outlook on fundamental credit trends and historically favorable valuations. Although the high yield market has largely recovered from the selloff in late 2008, we believe 2010 will see a continuation of the 2009 credit rally; it will be more muted, however, from a total return standpoint. Yields are still attractive at over 8%, spreads can tighten further compared to historical levels, and defaults are declining. We believe high yield stands to capitalize on these trends, along with improved economic expectations, low inflation and the Fed's diligence against tightening monetary policy.

Continued inflows to the high yield asset class will keep a strong technical bid in the market, as well. Investors who put large amounts of capital in safer and shorter-maturity assets during the credit

crisis are still looking to reallocate their assets among higher-risk and higher-yielding assets. Money market mutual funds totaled \$3 trillion at the end of March, which is down from their peak of around \$3.9 trillion in February of 2009 but still well above historical levels, according to the Investment Company Institute. We believe this asset class, given its yields – which are significantly better than Treasuries and high-grade credits – and its risk level – which is lower than equities, will attract investors who are seeking a balanced risk-return profile over the foreseeable future.

Nevertheless, the unemployment rate remains high, at close to 10%, consumer spending is unlikely to revert back to prerecession levels, and the uncertainty of sovereign risk in some European countries is still heightened. Thus, we believe 2010 will be driven less by beta and more by idiosyncratic, security-specific, risk. We would like to reiterate our recommendation of an overweight to BB and B rated bonds, due to the risk/reward opportunities, and a focus on credit selection.