

Market Review

The convertible marketplace moved up sharply – 9.2% – in the quarter, mostly due to underlying equities, which advanced 12.3%. Risk appetite reversed and increased this quarter, as the Fed indicated its willingness to support further quantitative easing. In addition, expectations for a double-dip recession have moderated somewhat on selectively better economic releases.

Speculative grade and small and mid cap stocks outperformed, while growth beat value as the risk trade regained favor. Cyclical stocks were strong, and transports, consumer discretionary and industrials performed best. Investors generally increased their risk weighting as European sovereign debt fears subsided, expectations for further Fed easing increased and the weak U.S. Dollar (USD) drove capital markets.

Interest rates on Treasuries continued to fall because investors expected an extended loose monetary profile, and U.S. debt remained the preferred safe-haven instrument. In addition, spreads were tighter, and all capital markets were better bid in the quarter.

The 2010 trend toward below-average issuance continued, with just \$7 billion in new issuance for the third quarter. The trend toward smaller deal sizes also remained in place.

From a bond perspective, investors continue to look for yield in a very low interest rate environment. This has pushed spreads to pre-recession levels and lowered the implied default rate dramatically. In equities, the trend was positive in the quarter, as USD debasement and continued government support have increased interest in risk assets.

Outlook and Strategy

The consensus for a more moderate growth profile into 2011 is getting closer to our viewpoint, as the economists and the Fed have lowered their GDP expectations. They're still more optimistic than we are, however. We think the GDP recovery is largely statistical, because the underlying fundamentals of the economy remain weak. As a result, our position remains cautious.

We expect earnings to be in line with or slightly better than projected for the third quarter. We expect guidance to be cautious and muted. As managers lock in gains and economic numbers get softer, we foresee expectations increasing for another round of quantitative easing. This could keep an underlying bid in equities and bonds.

We still favor gold as a hedge against USD debasement, and as a safety investment in an inflationary or deflationary environment. We also like healthcare and consumer staples. The convert marketplace has been moving up with all other asset classes as all capital markets are being better bid.

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Source: Barclays Capital; J.P. Morgan; AMG Data Services; Moody's Investors Service