Core Aggregate
Commentary

Third Quarter 2009

Market Review

With a GDP of -0.7%, the second quarter of 2009 was the fourth consecutive quarter for negative GDP growth – the longest trend since records began in 1947. North American economic growth was led down by the deteriorating labor market and an ailing and over-levered consumer, who continued to save rather than spend. We are seeing signs of stability in the housing market, and government stimulus programs have given life to consumer spending. We expect growth to have turned positive in the third quarter and remain so for the rest of the year. We expect a slow and muted recovery in 2010, however, as labor markets remain weak, consumers are further challenged by unemployment, and one-time stimulus effects fade.

The Federal Open Market Committee (FOMC) met two times in the third quarter and held the federal funds rate steady between 0% and 0.25%, stating "economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period" in both its August and September statements, a repeat from the second quarter. The FOMC also began to discuss exit strategies from the quantitative easing programs initiated earlier this year. While they are attempting to exit the programs slowly, they will undoubtedly have an impact on capital markets.

Capital markets stabilized further in the third quarter. The Barclays Capital U.S. Aggregate Index outperformed duration-adjusted Treasuries by 198 basis points (bps) in the third quarter, with an absolute return of 3.74%. Substantial amounts of cash continue to flow into the market, which has led to a strong technical backdrop for all fixed income assets. The increased demand led to a decrease in interest rates in the third quarter, even in the face of record supply. The 10-year Treasury note decreased by 23 bps to end the quarter at 3.30%, while the two-year Treasury note decreased by 16 bps to end the quarter at 0.95%.

As the economic outlook improved and cash flows into risky assets increased, risk appetites continued to increase, and liquidity improved. This led to a tightening of spreads across all asset classes and positive returns relative to U.S. Treasuries. The best-performing asset classes in the third quarter, relative to duration-adjusted Treasuries, were once again high yield corporate bonds, at 12.33%; commercial mortgage-backed securities, at 10.90%; investment grade corporate bonds, at 5.56%; and asset-backed securities, at 4.97%. The less-risky asset classes such as U.S. agencies and U.S. mortgage-backed securities outperformed by only .58% and 1.12%, respectively.

Market Outlook and Strategy

The bottoming of the housing market and improved consumer spending are among several signs that indicate the economy is no longer contracting. Consumer activity remains constrained by unemployment and increased savings, however, so the pace of recovery will be slow and drawn out, and markets will remain volatile.

We expect underlying fundamentals to improve with the economy but remain relatively weak across all asset classes. The strong technicals currently in place will give way to weaker technicals in 2010. As the FOMC and U.S. Treasury slow and eventually end quantitative easing, the interaction of public purchases with private purchases will change, causing additional volatility. Valuations have tightened substantially in 2009 but remain at historically attractive levels, compensating investors for the reduced risk they are now taking on while still making them attractive relative to U.S. Treasuries. Interest rates will remain low in the near term as the recovery and inflation remain muted and risk appetites decrease into yearend. Interest rates should rise in 2010, as the recovery slowly continues and the FOMC begins to tighten monetary policy in the second half of the year.

Fixed income investments remain an important tool for protecting investors against volatility while providing potential for strong returns. Security selection and asset allocation will continue driving returns in this environment. We expect liquidity to tighten up as we approach yearend, and we foresee spread widening toward the end of the year, as well. We will remain overweight to spread product, because we believe most asset classes will outperform Treasuries.