DWIGHT
ASSET MANAGEMENT COMPANY

ECONOMIC & BOND MARKET
QUARTERLY UPDATE

FIRST QUARTER 2009

CMBS: Finding Value in a Volatile Market

Commercial mortgage-backed securities (CMBS) continue to be a core investment component within Dwight-managed strategies. Given recent volatility, it is important to take stock of our holdings and methodology when it comes to trading within the CMBS sector.

Jason Golder
Vice President
Portfolio Manager: CMBS

Recent Market Events

The year began much like 2008 ended, as investors concentrated on the deteriorating economy and the subsequent weakness in the commercial real estate market. Jittery consumers increased savings and decreased spending, leading to retail weakness that manifested itself in various bankruptcies and store closings. Large empty spaces that resulted from Linens 'N Things and Circuit City closings not only hurt the image and rent capacity of store space, but in certain instances these closings also led to contractual contingencies allowing surrounding retail tenants to demand lower lease payments.

Meanwhile, continued weakness in the finance industry led to a consolidation in banking, brokerage, and ancillary businesses that has contributed to consolidation of office space. This decrease in demand for office space has crept into the strongest markets of New York City and Chicago. Headline loans such as Peter Cooper Village/Stuyvesant Town and the Riverton Apartments were aggressively underwritten and predicated on regulatory concessions and the ability to increase rental rates in the future. Economic weakness and legal issues have contributed to the headwinds facing the cash flow projections underlying these loans.

On the positive side, the government has introduced more details of their economic stimulus plan, and CMBS is now in the mix. The market has rallied as investors have some hope that the CMBS market will get a boost from public and private funds helping to "normalize" pricing. Currently the lack of willing lenders has made pricing for new loans or refinancing far too onerous, locking up the market. Government aid may help buyers and sellers of commercial real estate find a level at which new loans can be generated and the refinancing of current loans can be completed. This would allow good properties to function in a consistent manner and eliminate the need for forced sales that depress the values of commercial real estate.

The Case for Security Selection

There are two significant ways for a sector portfolio manager to measure performance in the world of fixed income; how the sector will perform compared to the universe of bonds, and how the securities selected will perform versus the rest of the sector and the universe at large. In past economic cycles CMBS has tended to be

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Fixed Income Sector Review

CORPORATES

After a tumultuous fourth quarter, the corporate bond market began to show some signs of stability in 2009. Investment-grade corporates posted a total return of -1.93% and underperformed duration-matched Treasuries by 21 basis points, ending the quarter at an option-adjusted spread (OAS) of 543 basis points.

Attractive valuations and reduced fears about the state of the financial system drew broad-based interest in corporate credit, causing spreads to tighten meaningfully in the month of January. New issue supply was well received as issuers were not forced to pay as much to bring a new deal to market, though that trend later reversed amid deteriorating economic fundamentals.

Skepticism over the success of evolving federal programs and populist outrage that emanated from Washington weighed heavily on financials. Financials performed poorly as weakness in the latter half of the quarter overwhelmed the strength exhibited in January, resulting in a negative excess return of 662 basis points for the period. Industrials and utilities fared better, however, posting positive excess

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***CMBS: Finding Value in a Volatile Market**, continued from the front page*

a lagging economic indicator. We expect the sector to continue to show weakness after the economy begins to recover, and we therefore continue to favor security selection as our preferred means of performance.

When Dwight analyzes CMBS bonds, we look at several factors:

1. Deal Structure: Dwight invests primarily in conduit and fusion CMBS transactions. These deals consist of many commercial real estate loans that are pooled together in a trust, which is then divided into tranches that provide various cash flows. The cash flows are usually broken into senior tranches that receive prepayments and take the first planned principal and interest payments. Within this block, additional tranching allows for different cash flow tenors, and furthermore, breaks out different types of cash flow (amortizing versus balloon payments). Below these senior tranches are the mezzanine and junior tranches that support the senior pieces and provide a measure of over-collateralization. The mezzanine and junior tranches pay interest and principal in a waterfall pattern (one class receives all scheduled principal and then the next begins to pay, etc.). In periods of heightened volatility, Dwight looks to invest in the senior tranches that provide the most protection in the waterfall. By investing in these tranches, we accept the first claim on principal and are protected from defaults and losses by the mezzanine and junior tranches.

2. Seasoning: We generally look for bonds that were originated prior to 2005. While there are performing loans and solid securities from 2006-2008, we have generally found value in earlier vintages. One reason for this is that loans underwritten before 2005 were on properties that experienced some price appreciation prior to the high-water mark in 2007 and 2008. This limits the downside of property depreciation we have seen during the last two years. The earlier vintage loans have also had time to "cure." Many of these loans have experienced amortization or voluntary principal prepayment so they currently have lower loan balances and in a distressed sale would still hold some value. Finally, the underwriting standards prior to 2005 were much more stringent. Fewer loans were underwritten based on pro-forma assumptions that included relying on future rent increases. Relying on real, measurable rent payments is preferable to projections that ultimately may not materialize.

3. Loan-Level Detail: In any deal it is important to look at loan stratifications. We look at the deal's weighted-average loan to value, debt service coverage, amount of interest-only loans, delinquencies, tenant concentrations, state concentrations, and amount of defeased or disposed debt, among other factors. We also look at the types of loans. In a volatile environment, it is often preferable to own trophy assets in large, well-supported markets as opposed to certain depressed assets in tertiary markets.

4. Relative Value: When evaluating two bonds we may, under certain circumstances, purchase the bond with less-appealing characteristics if the price creates a positive risk/return profile. If a 2007-originated bond is priced at thirty cents on the dollar, the depressed price and subsequent high yield may provide more positive risk/return characteristics than the deal structure and seasoning of a 2003 bond priced at ninety cents.

Conclusion

We expect commercial real estate fundamentals to continue to deteriorate as a result of economic weakness. We also expect CMBS loan performance to lag the overall economic cycle and remain weak for some time after the economy begins to recover. Nevertheless, we continue to believe that the CMBS sector provides relative-value opportunities. Concentrating on sector selection allows Dwight to hold solid credits that can survive widespread economic stress while providing the opportunity to benefit from a sector rebound resulting from government intervention or otherwise. We will look to concentrate in bonds that are higher in the capital structure and tend to be more seasoned, while also seeking deals that contain solid properties and structural protection. Weakness in the sector has already been largely priced into the market and many very good bonds carry distressed-dollar prices. Strong analysis and process can yield bonds providing solid carry and principal-upside potential relative to other sectors in the fixed income universe while managing the risk to our portfolios. ■

__Fixed Income Sector Review,__ continued from the front page

returns of 331 and 606 basis points, respectively.

Over the course of the first quarter, we transitioned from a modest underweight to a modest overweight position in the corporate sector. We added credit exposure to industrial and utility names, mostly using the primary market as new issue premiums provided very attractive entry levels. We continue to focus on higher-quality credits that have been unduly punished by the current market environment and that are well-positioned to manage through a difficult economic landscape. We maintain an overweight to the banking sector as it provides compelling value and benefits from strong federal support. Going forward we expect to maintain an overweight to corporate bonds, with a watchful eye for early signals of overall economic stability that could provide the incentive to add more cyclically-sensitive names.

MORTGAGE-BACKED SECURITIES

The mortgage-backed securities (MBS) sector exhibited strong performance in the first quarter of 2009, posting a total return of 2.20% and returning 172 basis points relative to duration-matched Treasuries.

The Fed announced at year-end that it would begin a program to purchase $500 billion in MBS by the end of June. This led to significant, but relatively short-lived, price appreciation as both originators and money managers took profits on their mortgage positions. MBS prices received another boost in March, however, when the Fed announced that it would be extending the program through year-end and buying an additional $750 billion in MBS. This produced significant outperformance, which we expect to continue into the next quarter. The program also pushed mortgage rates near historic lows, marking the beginnings of a refinancing wave and causing the prepayment speeds on much of the universe of outstanding mortgages to increase.

Non-agency mortgages had a volatile quarter as rating agencies continued to downgrade non-agency bonds more frequently and more aggressively. As a result, many investors were forced to sell downgraded securities into a weakened market. Recent programs announced by the Fed have also benefited the non-agency mortgage sector, though, and prices have since risen substantially.

We expect to maintain our overweight position in MBS until the Fed indicates a plan to slow its purchases. We will look to agency MBS that we expect to prepay at a slower rate than the broader universe to insulate our portfolios from increasing prepayment speeds. With regard to the non-agency sector, we have been selling bonds that have exhibited deteriorating performance and those that are at risk of being downgraded. We continue to hold our core position of seasoned bonds in this sector. As a whole, the MBS sector continues to provide attractive returns. Agency MBS are still attractive relative to other government-backed securities and non-agency MBS appear attractive relative to other credit sectors.

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First Quarter 2009 Sector Statistics*

FIRST Quarter 2009

Sector	Duration (years)	Credit Quality	Total Return (%)	Excess Return (%)
Aggregate	3.73	AA1/AA2	0.12	0.66
Treasury	5.40	AAA/AAA	-1.32	
Agency	3.51	AAA/AA1	-0.14	0.36
Corporate	5.96	A2/A3	-1.93	-0.21
MBS Fixed Rate	1.54	AAA/AAA	2.20	1.72
CMBS	3.86	AAA/AA1	-1.87	-1.42
ABS	2.94	AAA/AA1	7.56	7.66
High-Yield	4.10	B1/B2	5.98	6.36
Global Agg Ex USD	5.93	*Hedged*	-0.07	-0.22
Global Agg Ex USD	5.93	*Unhedged*	-5.44	-0.23

*Source: Barclays Capital Indices. Excess returns represent returns over duration-matched Treasuries. Credit quality represents market-weighted average credit quality for the indicated sector expressed in Moody's nomenclature. The Barclays Capital U.S. High Yield Index and Global Agg. Ex USD are not components of the investment-grade U.S. Aggregate Index.

Fixed Income Sector Review, *continued from page 3*

COMMERCIAL MORTGAGE-BACKED SECURITIES

The deterioration in commercial real estate fundamentals and lockdown of the credit markets drove commercial mortgage-backed securities (CMBS) spreads wider for the first two months of the year. This performance turned around in March, however, as promises of government support helped the sector to considerably outperform. The sector provided a total return of -187 basis points for the quarter and underperformed duration-matched Treasuries by 142 basis points.

The year began with uncertainty, as the new presidential administration put considerable heft behind the residential housing market and banking sectors but left support plans for CMBS vague at best. Meanwhile, several factors weighed heavily on the sector during the quarter as the financial sector experienced massive consolidation, retailers suffered from a reversal of consumer-spending habits, and business and vacation travel dried up. The multi-family sector was also unable to escape the downturn as loans on several properties that were aggressively underwritten and predicated on the ability to raise rents in upcoming years were unable to make debt payments. The greatest burden for the CMBS market, however, was a continued lack of credit. Traditional lenders stayed on the sidelines, making it difficult to buy or sell commercial real estate or even to refinance existing loans. Even performing assets were unable to refinance out of upcoming balloon loans into extended terms.

March provided a measure of reprieve, though, as new government programs came to the fore and support of the secondary CMBS market tightened spreads considerably. As prices began to "normalize," the potential for buyers and sellers to find a clearing level for property transactions and the possibility of obtaining reasonable financing rates provided hope that credit might return to the CMBS market.

We expect CMBS loan performance to lag the overall economic cycle and remain weak as the economy begins to recover. Nevertheless, we maintain our overweight position as we continue to favor the sector as a relative-value investment. We will continue to concentrate on bonds that are higher in the capital structure and those with more seasoning as they provide more stringent underwriting standards and less price depreciation from recent 2007 highs.

ASSET-BACKED SECURITIES

The biggest news surrounding the asset-backed securities (ABS) market during the first quarter was the official launch of the Term Asset-Backed Securities Loan Facility (TALF), which led to both spread tightening and new issuance. The market absorbed more than $8 billion in TALF-eligible ABS during a one-week period in March, after seeing virtually no issuance during the prior two months. Investors jumped back into the sector in anticipation of the program and ABS outperformed all other spread sectors as a result, posting a total return of 7.56% and outperforming duration-matched Treasuries by 7.66% for the quarter.

Despite deteriorating consumer fundamentals and weaker trust performance, credit cards rallied hard, besting duration-matched Treasuries by 1228 basis points and outperforming all other ABS subsectors. Auto spreads also staged a big rally, as The Manheim Used Vehicle Index gained 8.3%, issuers had access to TALF, and the Obama administration announced that it would stand by new car warranties from GM and Chrysler in the event of a bankruptcy filing.

Home equities continued to drag on the ABS sector, underperforming duration-matched Treasuries by 1113 basis points during the quarter as house prices continued to fall. Cram-down legislation, which would allow bankruptcy judges to modify homeowners' payment terms, was passed by the House in March and also hurt price performance. On the positive side, the Public-Private Investment Program (PPIP) and TALF 2.0 were announced, but the fact that the programs would accept legacy securities (bonds originally rated AAA that have since been downgraded) was not enough to change negative sentiment.

Our strategy moving into the second quarter will be similar to that of the previous few—while we are seeing some signs of stabilization in economic data, we will move forward defensively and favor top-tier, AAA-rated assets with low spread duration. We

DWIGHT SECTOR SPECIALISTS

The Sector Review was written by the following sector specialists:

John Bisset, CFA
Corporates

Steve Clancy
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do not believe that there is enough spread pick up to extend very far along the maturity curve in consumer-based assets; therefore we will look to replace longer maturities with short-dated bonds. Finally, we will continue to let our home equity exposure decline through amortizations and select sales.

HIGH-YIELD

Despite continued economic deterioration and an increase in default activity, the high-yield market performed strongly in the first quarter, providing a total return of 5.98% and outperforming duration-matched Treasuries by 636 basis points. Market participants remained risk averse throughout the quarter as BBs soundly outperformed the lower credit tiers.

Primary market activity remained subdued as new issuance was largely confined to high-quality, well-known companies in fairly stable industries, such as energy. New issues typically came with a significant spread concession to existing paper as well as a sizable price discount. Concessions will likely diminish as the credit markets normalize and risk appetite returns.

Liquidity in the secondary market remains challenged due to the inability and unwillingness of banks and brokers to allocate capital to their sales and trading operations. This has resulted in abnormally-wide bid/ask spreads that have increased transaction costs. The persistence of the credit crunch and resultant lack of an open, affordable new issue market led many investors to remain overweight in higher-quality, shorter-maturity paper. Given the asymmetric demand for higher-quality paper, the market tended to hoard the good names and freely offer distressed credits.

Despite negative macroeconomic headwinds, lower earnings, and higher defaults, high yield will likely range trade with a positive bias for the balance of the year. We expect the primary market to continue its slow recovery as underwriters repair their balance sheets and rebuild capital levels. Healthier companies have already engaged in open-market purchases of their own debt at attractive yields. Accordingly, we expect companies that are credit challenged to be more proactive in debt reduction, and as a result, actual default levels may undershoot the levels implied by market spreads. Given compensatory market spreads and our view that the economy will begin to recover in the second half of 2009, we will look to increase spread duration and reach a bit lower in the credit spectrum. We will reassess this strategy, however, if the primary market fails to reopen, economic fundamentals fail to improve, or if we witness another wave of financial deleveraging.

MUNICIPAL BONDS

Municipal bonds exhibited their strongest quarterly performance in almost five years, returning 4.22% in the first quarter of 2009. New issue volume for the quarter totaled $84 billion, down just 0.2% from the first quarter of 2008.

Despite a much better tone, the municipal market remains bifurcated between high-grade and all other credits. The spread between AAA and BBB+ general obligation (GO) bonds stands at 240 basis points, or about 170 basis points wider than one year ago. Continued credit fears, slowing government revenue growth, and volatility continue to weigh on all but the most solid credits. Absent a substantial improvement in the economy, state deficits are likely to grow dramatically over the next few years.

Over the next several months, some of the $135 billion from the stimulus package should begin to flow to the states. This infusion should help to alleviate stress on municipalities and reduce budget deficits. Another program designed to assist states that was introduced during the quarter is the Build America Bond (BAB) program. BABs are tax credit bonds that allow state and local governments to access taxable debt markets. They provide a 35%-interest subsidy, payable to the issuer by the Treasury on the interest payment date, and will lower net borrowing costs.

We remain cautious and continue our focus on high-grade GOs and essential service revenue bonds. Municipal bonds are still trading at relatively cheap levels and should continue to provide attractive risk-adjusted returns. Additional issuance in the taxable markets under the BAB program may also provide opportunities for taxable investors to diversify their portfolios with high-quality municipal credits. ■

DWIGHT SECTOR SPECIALISTS

The Sector Review was written by the following sector specialists:

Sean Slein, CFA
High-Yield

Peter Milne
Asset-Backed Securities

Keith McCarthy
Municipal Bonds

Economic Update

Jane Caron, CFA
Chief Economic Strategist

The term recession seems inadequate to describe this downturn. Depression seems more appropriate, but historians will tell you that the depressions of the 1920s and 1930s were marked by double-digit declines in real gross national product. Indeed, the reason the term recession was adopted after the Great Depression was to avoid the negative connotations associated with the word depression, and to distinguish milder downturns from more crushing ones. Our forecast for a peak-to-trough decline in real GDP of 3.6% points to the deepest contraction in real output in the post–World War II era. Were it not for an unprecedented level of government support, I am certain that I would be writing about a depression rather than a recession. Then again, I would probably be unemployed, which reminds me of the old joke: A recession is when your neighbor loses his job. A depression is when you lose your job.

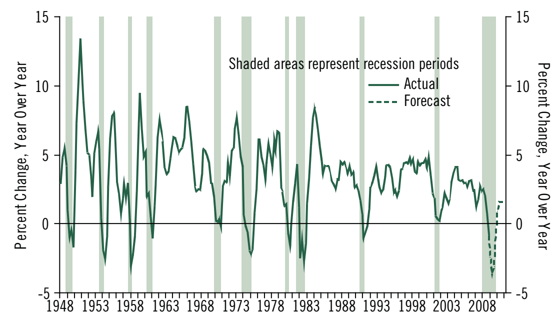
While the collapse in economic activity is striking, the reaction by public authorities is even more extraordinary. Congress has agreed to appropriate more than $1 trillion to directly support the economy, and the public balance sheet has also been used to extend trillions of additional dollars in guarantees and loans to support our financial system. The Federal Reserve, Treasury, and Federal Deposit Insurance Corporation (FDIC) have skillfully responded to this crisis by designing a variety of programs aimed at shoring the financial markets—we shudder to consider the state we would be in had they not done so. Still, in this process, the influence of the Fed and the FDIC appears to have extended beyond the levels envisioned in their charters. Mission creep is unavoidable given the consequences of inaction, but it will have to be addressed as part of the redesign of the regulatory architecture.

Congress, meanwhile, has been putting on quite the theatrical show in an effort to please voters and deflect blame. Unfortunately, some of the rhetoric coming from Washington has stoked panic conditions and diluted the impact of policies designed to stabilize the system. Nonetheless, in the first quarter, Congress passed the President's Economic Recovery and Reinvestment Act of 2009, a $787 billion fiscal stimulus plan. This package should provide meaningful support for the economy starting in the second quarter of this year. In addition, Congressional Democrats endorsed President Obama's ambitious and expensive budget proposal aimed at overhauling the government's role in healthcare, energy, education, and the environment.

According to the Congressional Budget Office (CBO), the federal budget deficit will reach $1.8 trillion this fiscal year (assuming that the budget is fully enacted), and it will not shrink below $650 billion in the visible future. In other words, huge fiscal deficits are expected to become structural rather than cyclical. The expected persistence of huge deficits points to an equally-massive increase in the public debt. The CBO expects publicly-held

Real Gross Domestic Product

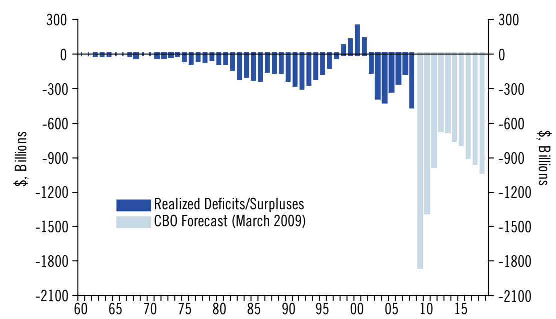
A very long and very deep recession



Source: Global Insight and NBER

Federal Budget (Fiscal Years)

CBO estimates based on the president's budget



Source: Congressional Budget Office

Treasury debt to surge from 41% of GDP in 2008 to 70% in 2012. Even if the budget is reduced significantly, the CBO still has a base-line estimate of 62%—not since World War II has there been an increase of this magnitude.

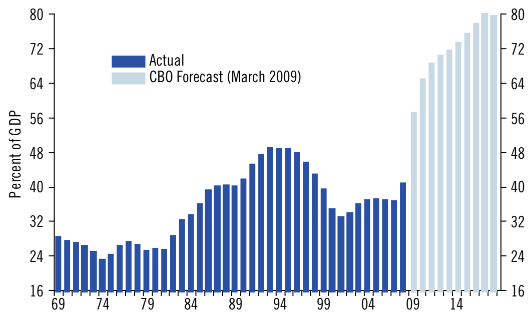
Not surprisingly, the Treasury is under significant pressure to come up with funding for the economic stimulus and financial system support programs. In the first quarter, record Treasury issuance put some upward pressure on interest rates, but because of continued safe-haven demand and little private sector issuance, the auctions were fully subscribed and interest rates did not rise significantly. Nonetheless, at the March Federal Open Market Committee (FOMC) meeting, the Fed agreed to begin actively buying Treasury securities in addition to expanding the purchasing program for mortgage-backed bonds and agency debentures.

The Fed's stated goal is to increase the level of monetary stimulus. The beneficial and probably purposeful side effect is that the Fed's actions have driven down the conforming mortgage rate to a level that encourages the vast majority of mortgage holders to refinance their loans. Moreover, new government policies to ease lending standards should help many mortgage holders who were previously restricted from refinancing because of high loan-to-value ratios. Ideally, the refinancing of mortgage loans will slow the foreclosure rate, reduce downward pressure on house prices, and relieve some of the bad debt problem at financial institutions.

The overarching goal of the myriad financial support programs is to significantly loosen the credit crunch. The Treasury's plan is to use the Public-Private Investment Program to remove some of the bad debt on banks' balance sheets, while simultaneously using the Capital Assistance Program to plug holes in the capital base at systemically important banks. Other support programs, particularly in the housing arena, will hopefully keep performing loans performing and further reduce the bad debt problem. If the Financial Stability Plan works, then credit conditions should significantly loosen, and the government will be

Federal Debt Held by the Public

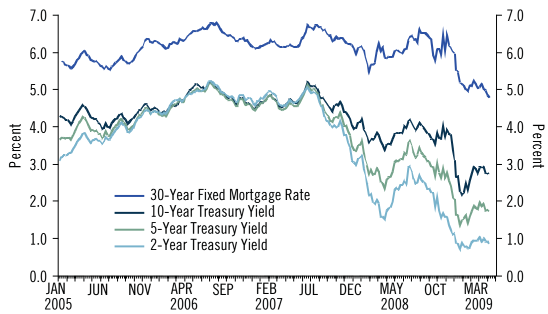
CBO estimates based on the president's budget



Source: Congressional Budget Office

Key Borrowing Rates

Fed buying has reduced rates



Source: Global Insight

able to transfer its role as capital provider back to the private sector. Skeptics rightfully point to the numerous problems with the Treasury's plan, but we believe public policy is finally moving in the right direction and that, in time, it will be successful.

We also believe the economy has entered a new phase in the economic cycle that brings it much closer to the bottom. During the first quarter, real consumption increased slightly following a collapse in the second half of last year. This is an important development because, if sustained, business managers will finally be able to bring their output level back in line with demand. Before, business managers could not cut capacity, inventories, and labor quickly enough because demand was falling at an even faster pace.

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***Economic Update**, continued from page 7*

- Real GDP growth, which plunged at a 6.3% annualized rate in the fourth quarter of 2008, is likely to fall at close to a 5.5% pace in the first quarter of 2009, before shrinking again at a 1–2% annualized rate in the second quarter. Over the summer, though, we expect the level of real GDP to reach a trough and begin to expand again in the second half of this year at roughly a 1.5–2.5% pace.

The labor market continues to experience dramatic declines, and it is the biggest risk to our outlook for stable consumption. During the first quarter, the average monthly decline in nonfarm payrolls was 685,000, and the unemployment rate increased to 8.5%. To date, more than 5 million jobs have been lost, and the unemployment rate has risen more than four points from its low. Looking ahead, we expect the unemployment rate to reach 10%, while total job loss reaches 7.5 or 8 million. Thus, we believe we are about two-thirds to three-quarters of the way through the labor market correction.

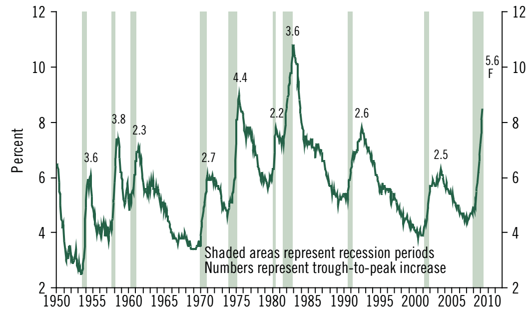
It is not unreasonable to wonder how we can expect real consumption to stabilize or increase in an environment where jobs are still being destroyed and wage and salary income is falling, particularly given that, with the level of wealth destruction that has occurred, investment income is also on the decline. Households are more focused on saving rather than buying, and even if a consumer wants to buy a durable good, access to credit remains severely impaired. All of these points are valid and are key reasons why we expect real consumption growth to be slow for several years to come.

Nonetheless, we expect consumption to expand. Real disposable incomes are rising, providing the wherewithal for consumption to increase despite the above-mentioned constraints. Government transfer payments, tax relief, and disinflation have lifted real disposable income and should continue to do so, on balance, for the next few quarters. As long as inflation does not pick up markedly during this period, consumption should expand. Ideally, in 2010, income growth will start to pick up just as government support begins to fade. This transition will have to be monitored closely because a failure here could result in a double-dip for the economy.

In summary, we believe the economy is headed for a turn this summer, but we characterize our view as cautiously optimistic. Once the economy turns, we believe economic growth will remain constrained for at least a couple of years and possibly longer. We are greatly concerned about the public deficit and the debt outlook for our country, and we are concerned that politics might interfere with prudence when it comes time for the Fed, the Treasury, and the FDIC to unwind their support policies. We hope that policymakers across all governments will be ever mindful of the long-term consequences of their actions and focus on the long-term protection of the economic and financial system which, despite current humbling conditions, is truly great. ■

Unemployment Rate

The unemployment rate is on track for a record increase

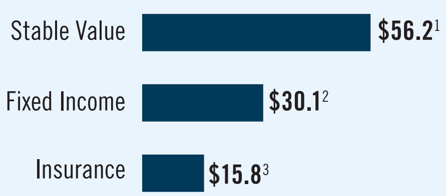


Source: Global Insight

Dwight Asset Management Company LLC
Total Assets as of 3/31/09:

$77.9 Billion

Assets by Product Strategy ($ Billions)



1. Includes assets also included in the fixed income total managed for stable value clients.
2. Includes assets also included in the stable value and insurance totals.
3. Includes assets also included in the fixed income total.

Please Note: Stable value separate account and commingled fund data is as of 2/28/09.

International Bond Market Update

Is it always darkest before dawn? Economies around the globe continued their path of destruction during the first quarter and global policy makers responded by further loosening monetary policy, announcing new fiscal stimulus packages, and warming up the printing presses. Indeed, governments not only sold more family silver, but they also mortgaged the future of coming generations. Not surprisingly, bond prices were buffeted by the inflationary forces of government policy and the deflationary forces of economic deterioration.

Ireland and Spain, where public finances have deteriorated significantly, were penalized by rating agencies in the first quarter. Both lost their coveted AAA ratings when they were downgraded to AA+. Greece, meanwhile, was downgraded to A-. If additional downgrades materialize, the resulting detrimental impact on borrowing costs would put an even greater burden on already-stretched finances.

The Irish government, once touted for its ability to create jobs through the implementation of an investor-friendly tax code, was forced to unveil the harshest austerity measures in the history of the Irish Republic. Ironically, the same boom the government helped to create led to an enormous real estate bubble that has since forced it to throw a life line to the domestic banking system, now crippled by a crash in the property market. The government announced plans to set up a “bad bank” that will buy between €80 and €90 billion of bank loans. To counteract this massive assumption of new debt, the administration in Dublin announced an emergency budget that proposes a series of significant tax increases while slashing expenditures. There is little doubt that if Ireland still had its own currency, the Irish punt, it would devalue it, but that of course is a moot point, since it is part of an exclusive club, the euro!

In the meantime, U.K. Prime Minister Gordon Brown is fighting for his political survival as the deadline for setting an election date in 2010 fast approaches. Public dissatisfaction with the government and a very deep recession has led to an increase in populist proposals amidst unprecedented government spending. Indeed, the budget deficit in the United Kingdom could reach 12.5% this year! Not surprisingly, the tremendous amount of debt issuance necessary to fund the government’s programs is putting significant upward pressure on Gilt rates. On March 5, the Bank of England (BOE) was the first of the major central banks to announce plans for a quantitative easing policy via the purchase of government bonds. The announcement and initial success (which, subsequently, was largely neutralized by the ambitious spending budget and a failed bond auction) may have inspired the Federal Reserve to follow suit shortly thereafter and begin buying Treasuries in the open market.

It is without doubt that, in the United States, public policy has slowed the pace of deterioration. From the U.S. and U.K. perspectives, the problem child is the euro zone, where stubborn fiscal conservatives, particularly in France and Germany, continue to resist the implementation of additional stimulus packages despite struggling economies. The pressure within the euro zone is building. The rift between the presumed “haves” (Germany, France, and The Netherlands) and the “have-nots” (Ireland, Portugal, Spain, and Greece) is growing because forced adherence to fiscal discipline is weighing more heavily on the have-nots. Moreover, the ongoing deterioration of the economic and fiscal health of central-eastern European nations like Hungary and the Baltic states poses a new risk to the European financial system. This is evidenced by the dramatic widening in interest rate spreads between nations, such as Austria, which have strong ties to their eastern European neighbors, and Germany, the poster child for post-war European stability. Indeed, spreads between the haves and have-nots have also risen appreciably.

Among the Asian nations, Japan is suffering from a catastrophic contraction of its export-driven economy. The Japanese government has counteracted with a third substantial stimulus package. Meanwhile, the

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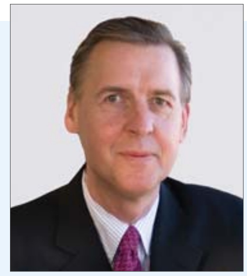

Peter Vutz
Senior Vice President
Portfolio Manager:
International, Non-Dollar

The dollar should remain supported in the near term by strong relative improvement in U.S. growth versus the euro zone and Japan.

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***International Bond Market Update,** continued from page 9*

largest creditor of the United States, China, is openly worried about its holdings of U.S. debt and is calling on our government to get its fiscal and economic affairs in order. Indeed, China has even suggested that a new reserve currency should be formed, which in our view is neither practical nor imminent at this point in time.

With respect to currencies, some fear that governments around the globe may use competitive devaluation and protectionist measures as weapons of last resort to stimulate their economies. We believe substantial foreign exchange intervention is unlikely at this time, but the Swiss National Bank successfully reduced the value of its currency in the first quarter by selling francs for euros. The risk is that other, larger central banks decide to follow the Swiss example if their economies remain weak for an extended period.

The dollar, meanwhile, should remain supported in the near term by strong relative improvement in U.S. growth versus the euro zone and Japan. Continued repatriation of overseas assets by U.S. investors led to further support for the U.S. dollar. Looking further ahead, we expect the dollar to weaken relative to the euro as foreigners seek to increase holdings in currencies other than the dollar, particularly in light of the ballooning debt in the United States.

Global long-term interest rates have risen since the beginning of the year despite the deepening global recession because of increased issuance of public debt and concerns about future inflation. Central banks, however, have generally managed to cap the rise in interest rates. Among the major central banks, only the ECB still has room to reduce its official rate, and we believe the ECB will cut this rate by another 25 basis points at its May meeting. Unlike other major central banks, the ECB cannot easily engage in quantitative easing via the purchase of sovereign debt, but we would not be surprised to see the ECB take alternative measures to add liquidity to the market.

In summary, we continue to be constructive on euro-denominated debt and foreign fixed income in general. However, the prevalent thought within the ECB is that the loose monetary policy of the Greenspan Fed made significant contributions to various asset bubbles. For this reason, we caution that the ECB is likely to be the first central bank ready to drain excess liquidity, and it is likely to do so at any cost. Thus, while the European economies are likely to follow the United States out of the recession, they may well lead the next interest rate cycle by tightening monetary policy first. ■

DWIGHT NEWS

Paul Norris Joins Dwight as MBS and ABS Sector Portfolio Manager

Paul Norris
Portfolio Manager: MBS, ABS

Paul Norris joined Dwight's Investment Team in February. Paul joins Steven Clancy and Peter Milne in managing the mortgage- and asset-backed securities sectors for Dwight's investment portfolios. Prior to joining Dwight, he served as Director of Mortgage Portfolio for Fannie Mae where he managed a $100 billion portfolio of mortgage products. Paul had also served as Director of Non-Mortgage Investments and ARM Specialist during his 13 years at Fannie Mae, as well as Fixed Income Portfolio Manager for Mercantile Safe Deposit & Trust, where he managed $1.0 billion of limited-duration institutional assets. Paul earned a Bachelor of Science in Business Administration from Towson University and a Master of Science in Finance from the University of Maryland. In his spare time, Paul enjoys tennis, golf, basketball, and competing in triathlons. ■

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