DWIGHT
ASSET MANAGEMENT COMPANY

ECONOMIC & BOND MARKET QUARTERLY UPDATE

SECOND QUARTER 2008

NOT ALL CENTRAL BANKS ARE CREATED EQUAL

Why We Should Be Concerned

On June 1, 2008, the European Central Bank (ECB) celebrated its tenth anniversary. We take this opportunity to reflect on what impact this institution has had on the Federal Reserve System and its monetary policy.

In the past, we took it for granted that the United States alone could determine its fate regarding domestic monetary policy. As the dollar replaced the British pound as the dominant reserve currency in the post–World War II era, the Federal Reserve emerged as the most powerful central bank in the world. The Fed effectively controlled monetary policy in the United States, and it either directly or indirectly influenced the monetary policies of smaller, otherwise independent central banks. The arrival of the European Central Bank and the euro, along with the ECB's approach to monetary policy over the past decade, has eroded the Fed's leadership position and has posed a significant risk to its global dominance among central banks.

Conflicting Mandates

Peter Vutz
Senior Vice President
International, Non-Dollar

It is important to remember that not all central banks are created equal. Very few central banks have mandates which mirror that of the Fed. This might not have held much significance in the past, but it may well change the way the Fed can maneuver in the future. The Federal Reserve is entrusted with setting U.S. monetary policy, and operates to promote the goals of price stability, maximum employment and moderate long-term interest rates. In contrast, the European Central Bank's mission is very clearly defined as

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CREDIT MARKETS REMAIN VULNERABLE DESPITE IMPROVEMENT IN SECOND QUARTER

Fixed Income Sector Review

Corporates

The corporate bond market rebounded from the depths of the credit crisis to outperform duration-matched Treasuries by 158 basis points in the second quarter of 2008. Spreads tightened 24 basis points during the period, making up some of the ground lost after spreads had widened 90 basis points in the first quarter.

The major problems that plagued the financials in the first quarter continued into the second, as brokers continued to write down assets and as mortgage and monoline insurers saw further downgrades from rating agencies. Fears of a systemic failure abated, however, allowing financials to outperform Treasuries during the quarter. Spreads have improved in several sectors within the corporate bond market since March. Nonetheless, concerns driven by a stretched consumer and by skyrocketing commodity prices drove many investors to reevaluate their corporate earnings outlook for the remainder of the year. Industrials generally posted positive excess returns, led by telecom, media, and technology, as earnings proved largely resistant to elevated commodity prices through the first quarter. In contrast, sectors with heavy exposure to commodities inputs, such as transportation, were among the worst performers. Airlines posted the only negative excess return across all industries.

The new issue market was robust in the second quarter. Many deals that were sidelined during the height of the credit crisis rushed to market at the first signs of a reemergence of demand. Year-to-date issuance through June, however, was

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Not All Central Banks Are Created Equal, continued from front cover

that of the "gatekeeper" whose main task it is "to maintain the euro's purchasing power and thus price stability in the euro area" (ECB 2008).

While it was hardly the first time that the ECB chose to follow a different (and we might say independent) way of addressing its economic and monetary concerns, many observers were nonetheless puzzled when the bank decided to hold rates steady last summer. Despite the Fed's decisive actions to counteract the potential impact of the credit market crisis on the U.S. economy, its European counterpart remained rather passive. As the Fed aggressively cut its key lending rate starting in June 2007 by a total of 325 basis points, the ECB supplied ample liquidity to the financial system to avert a cash crunch, but kept its key lending rate unchanged at 4%. Some questioned their sanity at the time, but the ECB affirmed its inflation-fighting credibility during this challenging period.

The arrival of the European Central Bank and the euro, along with the ECB's approach to monetary policy over the past decade, has eroded the Fed's leadership position and has posed a significant risk to its global dominance among central banks.

A Different Frame of Mind

Although some perceive the ECB to have an obsession with price stability, it is important to remember that this concept is firmly anchored in the psyche of Europeans. Price stability is particularly important to Germans as they recall, from either direct experience or history lessons, the hyperinflation that occurred during the Weimar Republic in 1923 and also in the aftermath of World War II. These are the events that ultimately led to the creation of the Bundesbank, the German central bank that is now a part of the ECB, and the deutschmark, Germany's postwar currency. In the years after its creation, the Bundesbank's no-nonsense approach toward price inflation earned the admiration of central bankers around the globe and resulted in the stability of the deutschmark. With the European Union's desire to replicate the success of Germany's postwar central banking system, the deutschmark and the Bundesbank served as blueprints for the euro and the European Central Bank. Thus the Bundesbank certainly helped overcome the angst of Germans, who had to give up their beloved deutschmark.

The task of the European Central Bank is obviously not without some challenges. After all, the ECB currently represents fifteen different countries, some of which have very diverse economic cycles and tax codes. Additionally, some member nations are struggling to preserve national autonomy. In this context, it comes as no surprise that in the face of a global economic downturn, countries like Germany, France, and the Netherlands show relatively resilient economic growth while other nations, like Ireland and Spain, have suffered greatly from the combination of a contracting economy and a monetary policy that is too restrictive for their needs.

We think that we are witnessing a corrective phase. As a result of the convergence of their economies, economic policies, and currencies leading up to the launch of the euro, countries like Ireland, Italy, and Spain profited from a long period of cheap money and historically low interest rates relative to their pre-euro local currencies. For Ireland and Spain, this low interest rate environment sparked an unprecedented construction and employment boom, which has now come to an abrupt end.

Shifting Regimes

The European Central Bank is not shy about pointing to its independence when responding to critics, and until recently has repeatedly proved to be spot-on when formulating the appropriate monetary policy. While we are not suggesting that the euro is about to replace the U.S. dollar as the main world reserve currency (at least not yet), the stewardship of the ECB might have set the stage for the emergence of the euro as a premier global reserve currency. The

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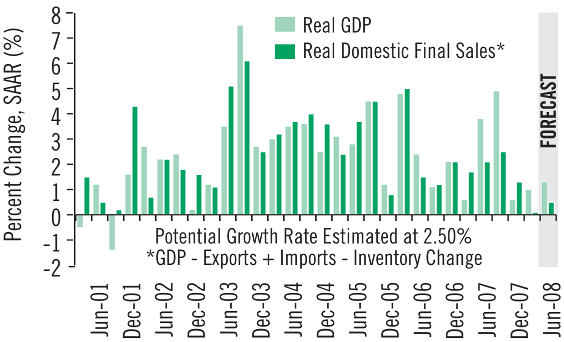
ECONOMIC UPDATE

Real GDP appears to have expanded in the first half of the year at a slightly better than 1% pace despite the ongoing housing market correction, a crisis in the financial markets, and surging food and gas prices (see Figure 1). This growth rate is in line with our full-year forecast of 1.5% real GDP growth, but it shows more strength than we expected when we declared the start of a recession at the beginning of the year. We are not changing our recession call because we believe that the economy is exhibiting recession-like characteristics. The economy will probably contract once the temporary lift from the rebate checks fades. Even if the economy does not contract, we expect decidedly sluggish growth to prevail for an extended period. In 2009, we expect GDP growth to barely top 1%.

Figure 1: Real GDP & Real Domestic Final Sales
Below Potential Growth Implies Deflationary Pressures



Source: Global Insight and Dwight

Optimists, who believe that the economy will regain its vigor early next year, point to the following support factors: loose fiscal and monetary policy, lean inventory and employment levels, little excess capacity in most sectors, and a housing market correction that is already well advanced. We agree with this assessment. Indeed, these supporting factors are embodied in our forecast. However, we think that the prodigal consumer will have to tighten his or her purse strings and keep them tight for an extended period. If so, the economy will be heavily constrained. After all, consumption comprises 71% of GDP (see Figure 2).

Our pessimistic view on the outlook for consumption is shared by consumers themselves (see Figure 3, next page). According to the University of Michigan Index of Consumer Sentiment, overall confidence fell in June to its weakest level since 1980. Meanwhile, the expectations component of the Conference Board Consumer Confidence Index reached an all-time low for the 40-year history of the series. Consumers are facing very stiff headwinds in the form of slowing income growth, declining wealth, surging nondiscretionary expenses, and limited access to credit. Some households are also experiencing rising debt service costs. In the past, consumers have been able to use debt to maintain their spending patterns when real disposable income growth was not sufficient, but in the current credit-restrained environment, cutbacks are necessary.

While we anticipate a recession, we do not anticipate a 1970s-style stagflation period. Granted, there are similarities between now and then, with oil and food

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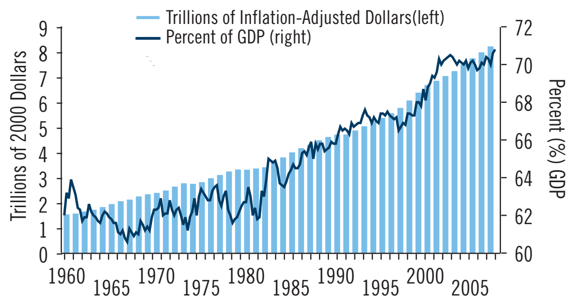
Figure 2: Consumption: Level & Percent of GDP
The Consumer's Share of GDP Is Now Over 70%



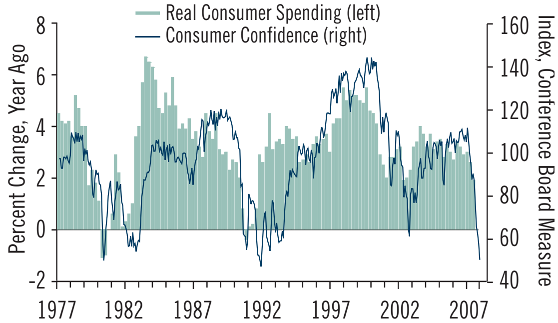
Source: Global Insight

Jane Caron, CFA
Chief Economic Strategist

Economic Update, continued from page 3

prices surging and the dollar depreciating, but core consumer inflation is not headed to a double-digit pace in the current growth-constrained environment. The only scenarios that could bring that about would require a return to protectionism, price controls, wage indexation, and/or financial market controls, and we do not believe that Washington policymakers will go very far down these regressive paths. There is a risk that Washington might approve another round of tax rebates, which could temporarily boost inflation, but we hope that this lesson was learned this summer. There is also a risk that Washington will act in a more protectionist fashion, but we doubt that progress made in recent years will be undone. As realists, we recognize that Washington can surprise us, particularly when "change" could be the mandate after the next election.

Figure 3: Consumer Spending vs. Confidence
The Sharp Decline in Confidence Portends Much Slower Consumption



Source: Global Insight

We expect core CPI to edge higher toward 2.5% in coming months, while headline inflation rises a point or so to surpass 5% (see Figure 4). We do not expect the Federal Reserve to respond to higher headline inflation with tighter monetary policy, but it will probably continue to send signals that it is prepared to tighten if upside inflation risks start to dominate downside growth risks. The Fed can do little to control the price of commodities, which is now the sole source of inflation. A tightening policy with a goal of destroying U.S. demand in an effort to reduce emerging-market demand and to bring down food and energy prices is nonsensical. A better plan would be for the Fed to use an old style of policymaking called "opportunistic disinflation." In this practice, the FOMC would not raise interest rates when economic growth is already on track to slow to a level that would relieve rising inflation pressure. The Fed is concerned about maintaining its hard-won credibility on the inflation-fighting front. If it does not raise interest rates, and the economy fails to slow enough to keep inflation expectations and wage growth in check, then the Fed risks losing the public's confidence. This could result in inflation becoming embedded, as it did before Fed Chairman Volcker took the helm. Thus, if it becomes evident that the economy is regaining its vigor, the Fed should tighten policy.

Our read on the economy is that there is little risk that economic growth will be fast enough to foster a significant increase in the core inflation rate. Nonfarm

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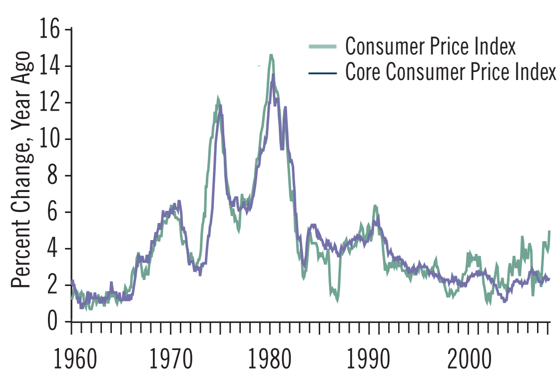
Figure 4: Consumer Price Indices: Total & Core
Core Consumer Inflation Still Well Behaved



Source: Global Insight

Credit Markets Remain Vulnerable Despite Improvement in Second Quarter, continued from front cover

only slightly above levels in the first half of 2007. Given the continued uncertainty in the market, new issues proved to be an attractive way to invest during the second quarter as issuers were forced to price deals cheaply.

In light of our concerns surrounding the economic outlook, we remain underweight the corporate sector but continue to overweight financial institutions, given their compelling relative value versus industrials. Though the financial sector will continue to face strong headwinds in the second half of the year, healthy balance sheets and improved transparency among the better names in the sector strengthen our conviction in our positions. Furthermore, with respect to industrials, we are just beginning to experience the effects of a weaker economic environment on the consumer and on those industries exposed to elevated commodity prices. This leaves many other sectors more vulnerable to credit deterioration in the second half of 2008.

Mortgage-Backed Securities

The mortgage-backed securities (MBS) sector returned -0.49% for the second quarter of 2008. On a duration-adjusted basis, MBS returned 52 basis points over U.S. Treasuries during the quarter. Despite this relative outperformance, price action continued to be volatile, and liquidity remained poor.

During the first half of the quarter, MBS dramatically outperformed U.S. Treasuries as spreads narrowed significantly from the historically wide levels seen in March. The reduction of the capital restrictions placed on Fannie Mae, Freddie Mac, and some of the Federal Home Loan Banks helped stimulate demand for mortgages. Despite this renewed confidence, the sector's strong run eventually lost momentum, and relative value began to favor other asset classes.

Higher interest rates and tighter underwriting standards led to slowing prepayment speeds later in the quarter. As a result, fewer homeowners were refinancing their mortgages; this trend ignited investor fears that the durations of their MBS holdings were longer than originally expected. These factors led investors to reduce their allocations in favor of U.S. Treasuries, a pattern that continued throughout the quarter.

We maintain a neutral position in MBS, as we believe that the sector is fairly valued at current levels. Liquidity is still constrained; investor confidence remains tentative; and we expect mortgage supply to be limited, given the higher rates faced by borrowers looking to refinance. Investors have demonstrated a willingness to sell into strength, and we will remain neutral until valuations, sentiment, or liquidity conditions improve.

Commercial Mortgage-Backed Securities

Commercial mortgage-backed securities (CMBS) staged an impressive comeback in the second quarter, outperforming Treasuries by 2.6% on a duration-adjusted basis. CMBS posted the highest excess return of any major sector in the Lehman Aggregate Index and was the only sector within the index to post a positive total return during the quarter. The sector enjoyed considerable spread tightening that outweighed the rising interest rates that hurt performance in other sectors. CMBS saw strong demand from insurance companies and from money managers who were forced to look to the secondary market amid extremely light new issuance. Having seen the sector reach historical spreads and underperform every other sector except high-yield, CMBS investors took a step back and looked at the fundamental picture, moving to reinvest in relatively cheap securities.

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Liquidity is still constrained; investor confidence remains tentative; and we expect mortgage supply to be limited, given the higher rates faced by borrowers looking to refinance.

Credit Markets Remain Vulnerable Despite Improvement in Second Quarter, continued from page 5

- Demand was particularly strong for super-senior and seasoned, higher-quality securities, which led to a more pronounced tiering between the different vintages in the CMBS sector. Older vintage bonds (primarily those issued in 2005 and earlier) were especially coveted by investors, as they tend to offer more conservative underwriting and better credit characteristics relative to their recently issued counterparts. These seasoned securities also offer investors a longer performance history and a proven track record on the underlying loans.

Figure 5: Second Quarter 2008 Sector Statistics*

Sector	Duration (years)	Credit Quality	Total Return (%)	Excess Return (%)
Aggregate	4.68	AA1/AA2	-1.02	0.64
Treasury	5.15	AAA/AAA	-2.10	
Agency	3.65	AAA/AA1	-1.48	0.07
Corporate	6.27	A2/A3	-0.69	1.58
MBS Fixed Rate	3.81	AAA/AAA	-0.49	0.52
CMBS	4.79	AAA/AA1	0.18	2.60
ABS	3.32	AAA/AA1	-0.80	0.78
High-Yield	4.51	B1/B2	1.76	3.93
Global Agg Ex-USD	5.76	Hedged	-2.15	0.27
Global Agg Ex-USD	5.76	Unhedged	-3.96	0.28

*Source: Lehman Brothers Global Family of 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 Lehman Brothers U.S. High Yield Index and Global Agg Ex USD are not components of the investment-grade U.S. Aggregate Index.

The new issue market was extremely quiet in the second quarter, with only six new fixed rate conduit deals totaling $5.9 billion coming to market, a steep decline from the $46 billion issued during the same period last year. Issuance is likely to remain anemic until spreads tighten sufficiently to make securitization profitable for lending conduits. Market fundamentals showed some modest signs of deterioration during the second quarter, but overall delinquencies remain near historic lows. Nonetheless, the rise in delinquencies is likely to continue, reflecting weaker economic growth and softening demand for commercial space.

We continue to maintain our overweight to CMBS, favoring the higher-rated tiers of the credit spectrum and the more seasoned securities. Super-senior AAA bonds and conservatively underwritten, de-levered seasoned bonds continue to offer excellent value to investors on both a relative and an absolute basis. While these bonds are not immune to overall market fluctuations, we believe that CMBS will provide attractive spread income, as well as continued potential for spread tightening as market conditions normalize.

Asset-Backed Securities

The tone of the financial markets improved considerably during the second quarter, as buyers of high-quality, consumer-related assets returned to the market. Spreads hit their widest levels in March, but subsequently tightened throughout April, May, and most of June. As a result, the asset-backed securities (ABS) sector posted its first positive quarterly excess return in over a year, besting duration-matched Treasuries by 78 basis points. Credit cards, stranded cost utilities, and auto loans led the outperformance, comprising 232, 210, and 204 basis points of excess return, respectively.

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Credit Markets Remain Vulnerable Despite Improvement in Second Quarter, continued from page 6

- The home equity loan (HEL) portion of the Lehman Aggregate Index once again underperformed, returning -5.04% relative to duration-matched Treasuries. The subprime market continued to trade poorly as de-levering in the bank and finance sector, further home price depreciation, and increasing foreclosures put more pressure on the various ABX indices. The AAAs traded lower as participants used the indices to hedge existing exposure or to express a negative view of the market. With no signs of stabilization in the housing market, and with continued uncertainty about the future of the monolines, investor confidence remained tenuous.

Spreads tightened dramatically in a very short period of time, and we believe they came too far, too fast. The consumer is being stretched very thin, as tight lending standards leave little room for error for those dealing with higher food and energy costs, along with falling home values. Given our cautious outlook on the consumer and the overall economy, we have utilized this tighter spread environment to reduce our exposure to longer auto and credit card positions in favor of shorter, higher-quality names.

We will continue to favor top-tier consumer assets but will concentrate our holdings in bonds with shorter maturities, allowing us to maintain a lower risk profile. We continue to believe that high-quality ABS collateral will outperform in the long run, but we expect spreads to remain volatile in the interim.

High-Yield

High-yield rebounded somewhat from its dismal first-quarter showing, providing a total return of 1.76% and outperforming Treasuries by 3.93%. Positive drivers included the decline in systemic risk, gradual improvement in liquidity conditions, short covering in a markedly oversold environment, and a meaningful reduction in the amount of hung-bridge financings held by banks and brokers. Positive performance was primarily front-loaded in the first 6 weeks of the quarter; those gains were later offset, as the likelihood of a slowing economy once again captured the attention of the market.

The market rally early in the quarter helped thaw the previously frozen primary market. New issuance was approximately $35 billion in the second quarter, well above the $8 billion first-quarter total. Given the lowered appetite for risk among market participants, most issuance was in the highest credit tier. Year-to-date new issuance was approximately $43 billion, about half the total for the same period last year. Secondary market liquidity remained under pressure during the quarter. Banks and brokers have been forced to divert precious capital from trading operations to shore up their ailing balance sheets. This strategy has increased the implicit cost of trading through wider bid-ask spreads and greater spread volatility. Spreads are currently factoring in a year-end default rate of approximately 6%, a forecast well in excess of today's trailing 12-month rate of

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Dwight Sector Specialists

The Sector Review was written by the following sector specialists:

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Josh Kruk, CFA
Mortgage-Backed Securities

Derrick Wulf, CFA
Commercial Mortgage-Backed Securities

Peter Milne
Asset-Backed Securities

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Municipal Bonds

Peter Vutz
International, Non-Dollar

DWIGHT ASSET MANAGEMENT COMPANY

Credit Markets Remain Vulnerable Despite Improvement in Second Quarter, continued from page 7

Barring a sharp drop in gasoline and food prices, we believe that clear signs of a recession will emerge in the second half of this year and that concerns about inflation will dissipate in 2009.

2.3%. While an increase in defaults to 6% by year-end is relatively aggressive, we would not be surprised if the market began to factor in an even higher expected default rate as the year progresses.

Despite the current manageable default rate, market sentiment remains cautious. Spreads reflect both higher credit risk and increased liquidity premiums, and it is not yet clear to what extent a more significant economic slowdown is being priced into the market. As the year progresses, we believe that market participants will focus less on systemic risk and more on minimizing idiosyncratic risk. Accordingly, we will continue to trade up in credit quality and to avoid sectors that lack near-term recovery catalysts, such as autos and consumer discretionary retail. If the downturn is less protracted than we suspect and the technical overhang is removed, the high-yield market could continue its recent momentum and generate positive excess returns in the second half of the year.

Municipal Bonds

The second quarter came to an end with municipal bonds trading at historically cheap levels. The Lehman Municipal Bond Index returned 0.63% for the quarter, a 124 basis point improvement from its first quarter return of -0.61%. Year-to-date, municipal bonds have underperformed the Lehman U.S. Treasury Index by 221 basis points.

New issue volume for the second quarter totaled approximately $138 billion, down 4.1% compared to the same period in 2007. While the drop in issuance in the first half of 2008 was small, the composition of the new issue market changed dramatically. Fixed rate issuance fell $40 billion, while variable rate issuance climbed by over $50 billion as many issuers refinanced their auction rate securities with variable rate demand and put bonds. Most dramatically, bonds issued with insurance dropped from 48.5% to only 23.5%, with just three viable insurers remaining in the market.

The municipal bond market continues to struggle with the credit crunch, the housing bust, monoline downgrades, shrinking consumption, higher mortgage payments, bankruptcies, and falling revenue from sales, income, and property taxes. We expect to see this continue into the near future with more job cuts at both state and local levels. In addition, the United States Supreme Court ruled in Kentucky vs. Davis that states can continue taxing interest on out-of-state municipal bonds while exempting interest on their own bonds. This overturned the Kentucky appellate court's decision that current practice discriminates against interstate commerce. As expected, the Supreme Court was reluctant to hand down a decision that would upend the entire $2.6 trillion municipal bond market.

Though there are reasons to remain cautious, our outlook for the municipal bond market is optimistic. Should the volatility and dislocation persist, we believe that high-quality credits will outperform over the long term. The municipal bond market continues to be of high quality and low risk (second only to U.S. Treasuries), offering investors compelling risk-adjusted return potential.

Non-Dollar

In the second quarter, the Lehman Global Aggregate Index ex-USD returned -3.96% on an unhedged basis relative to the U.S. dollar. The same index returned -2.15% on a hedged basis. During the quarter, the downside risks to global growth clearly gained momentum. World economies faced substantial headwinds from record oil prices, surging food prices, and continued depressed financial conditions. Central banks around the globe are raising rates because surging inflation pressures have replaced the global credit crunch as the primary threat to domestic economies.

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Not All Central Banks Are Created Equal, continued from page 2

recent weakness of the U.S. dollar has supported calls for a second reserve currency, and the euro appears to be ready to fill that role, creating a potential predicament for the Fed.

When the ECB shifted gears after its policy meeting on June 5 and put the market on notice for a potential rate hike in July of this year, the Federal Reserve quickly mirrored its hawkish anti-inflation rhetoric. On July 3, the ECB adhered to its warning and increased the key lending rate by 25 basis points to 4.25%. This raises a question about what options the Fed might have now and in the future if and when the ECB signals a series of rate hikes while our economy is still in need of a more accommodative policy. If the Fed stands idly by, there is a risk that the U.S. dollar will weaken further and exacerbate the U.S. inflation problem. Alternatively, a tighter policy would probably deepen the economic downturn.

The arrival of the ECB as a major player among central banks clearly changes the game, creating the potential for a catastrophic policy error on this side of the Atlantic or the other. We will be watching this closely. ■

Written by Peter Vutz
Senior Vice President
International, Non-Dollar

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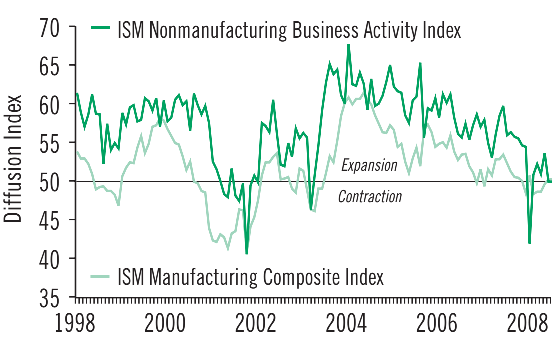
employment has fallen in every month so far this year, with an average decline of 73,000. The unemployment rate has risen half a percentage point to 5.5% and is poised to rise to 6% this year. Average hourly earnings have risen less than 3.5% in the last year, which is below the increase in the cost of living. The ISM indices are consistent with stagnation and will probably soon point to a contraction in activity if energy prices remain elevated (see Figure 6).

Figure 6: ISM Purchasing Manager Indices
Stagnation



Source: Global Insight

Barring a sharp drop in gasoline and food prices, we believe that clear signs of a recession will emerge in the second half of this year and that concerns about inflation will dissipate in 2009. Throughout this period we expect the Fed to keep the federal funds rate on hold, unless our pessimistic growth forecast is proved wrong. ■

Written by Jane Caron, CFA
Chief Economic Strategist

Credit Markets Remain Vulnerable Despite Improvement in Second Quarter, continued from page 8

- The economic expansion in the euro area is already deteriorating. In the month of May, the HICP—an indicator for inflation and price stability in the euro zone—showed a flash estimate of 4%, the highest reading since the introduction of the euro in 1999. Despite higher food and energy costs, tighter credit, slower corporate spending, and a strong currency, the European Central Bank (ECB) signaled a tightening after their June 5 meeting. The ensuing jump in volatility and the flattening of the yield curve (which even inverted temporarily) caused extreme pain among banks, brokers, and institutional investors.

The longer the upward pressure on food and energy prices continues, the greater the risks of a full-blown global recession.

Not unlike its European counterpart, the Bank of England (BOE) is also attempting to mitigate headline inflation in light of higher food and energy prices. The housing market is deteriorating at its fastest pace in history; the consumer is increasingly stretched thin; and PMI surveys, which measure growth in manufacturing, are signaling pessimism on all fronts. Under these circumstances, the BOE's mandate to keep headline inflation below its 2% target rate renders it effectively helpless. To fulfill its mandate, the BOE cannot accommodate the market with a necessary rate cut in this boom-to-bust scenario.

Markets have already priced in the possibility of a second rate hike by the ECB later in the year. Some are even pricing in the possibility of a rate hike from the BOE, an action that would undoubtedly prolong the pain for the United Kingdom's economy. In our opinion, when inflation pressures finally ease, the tightening bias taken by the ECB will ultimately lead to a series of back-loaded rate cuts in 2009, and the same will be true for the BOE if it follows suit.

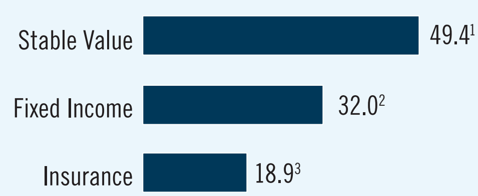
Meanwhile, in Japan, confidence levels in the retail sector dropped to an all-time low in the face of a cautious consumer. Japanese exporters are bracing themselves for the prospect of a slowdown at best and a full-blown global recession at worst.

While the market may be ahead of itself in pricing in a series of rate hikes over the coming months, the outcome ultimately depends on the central banks' abilities to deflate the global commodities bubble. The longer the upward pressure on food and energy prices continues, the greater the risks of a full-blown global recession. The U.S. dollar is being held hostage by the current cycle of higher commodity prices and rising interest rates outside the United States. While we still anticipate a recovery of the dollar, any sustainable appreciation will likely be on hold so long as these external forces persist. ■

Written by Dwight Sector Specialists

Dwight Asset Management Company LLC Total Assets as of 6/30/08: $73.2 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 5/31/08.

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