

Fixed Income Sector Review

GOVERNMENT-RELATED DEBT

Treasuries rallied sharply in the second quarter as the European sovereign debt crisis led to deteriorating financial conditions and a reduction of global economic growth forecasts. Stubbornly high unemployment, waning fiscal stimulus, and accommodative monetary policy increased the appeal of Treasuries, leading to declines in Treasury yields and a flattening of the curve. The strong rally in Treasuries led to a hefty 4.69% return for the Barclays Capital U.S. Treasuries Index, its best quarterly performance since the fourth quarter of 2008.

Notably soft inflation data caused TIPS to lag the performance of their non-indexed counterparts during the quarter, with implied inflation breakevens moving sharply lower during the period. Low resource utilization should keep inflation low in the near term, but steady demand growth should prevent the current disinflationary trend from turning into outright deflation.

A relative lack of new issuance in high-quality fixed income assets helped maintain a stable tone in the agency market during the quarter. As a result, agencies matched the performance of duration-adjusted Treasuries during the period, with their modest yield advantage offsetting the effects of slightly wider spreads. With an average option-adjusted spread of just over 30 basis points, however, we believe that agency debt is rich relative to other high-grade assets, and remain underweight the sector.

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Economic & Bond Market QUARTERLY UPDATE

SECOND QUARTER 2010

The Impact of Financial Reform

The Dodd-Frank bill, recently passed by Congress, can be considered the most far-reaching financial legislation in over 80 years. It will have a lasting impact on critical elements of the financial environment, including Federal Reserve oversight and transparency, rating agency protocol and behavior, credit risk retention, and derivatives treatment. Whether the legislation will actually serve to protect consumers or mitigate the risk of another financial crisis, however, remains unclear at best.

Of significance to the defined contribution and 529 plan marketplaces, the treatment of stable value wrap contracts—defined in earlier versions of the legislation as “swaps”—will be taken up by the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) over a 15-month study period. The SEC and CFTC have been

charged with consulting the Department of Labor, Treasury, and state regulators to address the following:

1. Should stable value wrap contracts be included within the definition of swaps? If the contracts are not defined as swaps, regulatory treatment of the contracts will remain unchanged.

2. If stable value wrap contracts are included within the definition of swaps, should they be exempt from treatment as such? The legislation requires the CFTC and SEC to issue regulations regarding the determination that they make on this issue. If it is determined that stable value wrap contracts are exempt, regulatory treatment of the contracts should remain unchanged.

3. If stable value wrap contracts are determined to fall within the definition of swaps and are not determined to be exempt from regulation, the CFTC and SEC must

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The Impact of Financial Reform, continued from the front page



Written by
David W. Starr
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Written by
William F. Gardner
Senior Client
Portfolio Manager

► develop and implement a regulatory framework that will address disclosure, capital, and reserve requirements, among other issues.

Under the Dodd-Frank bill, stable value wrap contracts will continue to operate under the existing regulatory framework during the study period. It is also important to note that the bill protects the status of all contracts in existence prior to the determination date, stating that these contracts will not be considered swaps nor will they be subject to the requirements of the bill, regardless of the outcome of the study. This “grandfathering” of existing contracts is a key element in providing certainty to plan sponsors regarding stable value wrap contracts.

While most stable value market practitioners viewed the original legislation’s treatment of stable value contracts as a clear case of “unintended consequences,” legislators on the conference committee did not exempt these contracts from such treatment. Accordingly, the stable value market, already constrained by an imbalance of wrap supply and demand, will be exposed to this 15-month period of further uncertainty as the regulatory bodies reach a determination.

Allowing a joint regulatory study was widely viewed as a positive outcome by stable value market participants. The additional time allows for a more reasoned approach with regulators to appropriately address and resolve outstanding issues in a manner that protects the asset class for plan sponsors and participants. Given the positive contribution stable value funds have made toward retirement security for millions of participants in the last 35 years, a more thorough analysis is warranted.

Dwight remains committed to providing capital preservation investment strategies in the form plan sponsors require and within the regulatory framework that is ultimately put in place. To that end, we are taking several actions to ensure that we continue to meet the capital preservation objectives of our clients:

- **Rethinking Stable Value Strategy:** We have engaged issuers and plan sponsors on a variety of asset strategies and contract terms that will bring greater uniformity to wrap contracts and address issuer concerns regarding investment guidelines, managing notional exposure, and providing greater liquidity to stable value portfolios. By doing so, we intend to provide plan sponsors with greater flexibility and clarity in using stable value while maintaining a risk/reward benefit critical to the retirement security of participants.

- **Enhancing Liability Modeling:** We have taken significant steps to improve the measurement of plan liabilities to help plan sponsors and issuers understand the associated risks and take the necessary steps to mitigate exposures. Our Enhanced Liability Model (ELM), designed to provide a transparent duration and allocation methodology for both plan sponsors and wrap providers, guides the overall duration, level of liquidity, and underlying asset mix that is appropriate for each client’s portfolio.

- **Developing Capital Preservation Alternatives:** Dwight has developed a variety of customizable cash, stable value, and short-term bond strategies. Given the confluence of market and regulatory constraints, it is likely that some plans will begin to offer capital preservation alternatives that allow for small net asset value fluctuations in addition to the stable net asset value strategies that are currently available.

Though the form of offerings in the capital preservation market has been evolving in response to market and regulatory pressures, it remains clear that participants require viable investment options that can serve as a foundation for building savings plans. We look forward to continuing our work with plan sponsors, consultants, and other market participants in offering leading investment strategies to meet those needs. ■

Dwight Asset
Management
Company LLC

**\$64.3
Billion**

**Total Assets
as of 6/30/10**

International Update

The second quarter proved to be another challenging one for international bond market investors. The European political establishment's initial inept response to the Greek debt crisis led predictably to a full-blown crisis, threatening peripheral European nations like Portugal and Spain and endangering the existence of the common currency. Finally giving in to the tremendous pressure of the financial markets, the governments of the European Union joined forces with the International Monetary Fund and crafted a rescue package totaling €750 billion to address potential liquidity problems in all peripheral European nations.

After months of wavering, the European Central Bank caved in light of the severity of the crisis, announcing its own tailor-made quantitative easing program to buy peripheral European government debt. The handling of the crisis may have caused permanent damage to the credibility of the ECB, and potential losses from the bond purchase program could lead to recapitalization needs that would further undermine the ECB's strength and independence. The damage caused by the initially tepid response fostered speculation in the eventual demise of the euro. We find these predictions premature and, at least for now, do not buy into this swan-song theory.

We do believe that weaker members, most notably Greece, might be tempted to leave the European common currency notwithstanding collateral damage to their own reputations. The rescue package bought time for the troubled peripherals, but the structural problems will take a herculean effort to resolve. We continue to question the resolve and willingness of the Greek government to stick to its stringent austerity package. We believe Greece will succumb to the temptation of short-changing bond market investors, most of whom are domiciled outside of Greece. We believe that a Greek debt restructuring will take place at some point in the future, most likely in two or three years.

Spain appears to have adequately addressed its problems, which are concentrated in the savings bank industry, by creating a rescue fund for the financial sector and initiating voluntary and involuntary merger policies within the savings bank sector. These actions have taken the pressure off the Spanish markets. The total cost to the government will be vast, though, if we include the stress on the social system that results from unemployment rates in excess of 20%. Only time will tell if the Spaniards are up to the challenge, but their government is off to a good start. The weaker euro has acted as somewhat of a stimulus package for the more competitive, export-oriented nations of northern Europe, but has not filtered down to nations under siege due to their necessary austerity measures.

A more modest rate of growth, which is now generally anticipated, is a growing concern. Europe's newfound faith in fiscal responsibility puts it at odds with our administration, which favors continued government intervention via public sector stimulus programs. If the Europeans succeed in averting a double-dip recession or deflation, they would certainly gain an edge over the public sector finances in the United States.

In the weeks to come all eyes will be on the stress tests which most European banks have to undergo. Not enough is known of the criteria used, but should they be perceived as too lenient, it would undermine the integrity of such tests and likely cause further market volatility. A credible test would certainly support a further relief rally in the financial sector.

Meanwhile, in the United Kingdom, recent elections produced no clear winner and led to a hung parliament. The conservative Prime Minister David Cameron formed a coalition government with the liberal party. His administration is off to a promising start, helping both U.K. asset prices and the British pound. While we give kudos to the early success of Mr. Cameron, we remain skeptical that such a tenuous coalition will survive the full term.



Written by
Peter Vutz
*Head of Corporate Credit
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Economic Update



Written by
Jane Caron, CFA
Chief Economic Strategist

Investor sentiment did an about-face in the second quarter. In April, 10-year Treasury yields increased to near 4% and the Dow rose above 11,000 as the self-reinforcing nature of the recovery was widely touted and corporate earnings beat expectations again. Economists, meanwhile, were busy debating when the Fed would remove the “extended period” language from the FOMC statement. By comparison, at the end of June, 10-year Treasury yields were under 3% and the Dow was below 10,000 as investors began to fear a sharp deceleration in economic activity or even a double dip.

What happened? Was the Greek crisis a flap of a butterfly’s wings?

In some ways this old metaphor, “Does the flap of a butterfly’s wings in Brazil set off a tornado in Texas?” applies: the Greek crisis occurred at a time when investors were sitting on large portfolio returns, and they reacted to uncertainty by reducing risk and realizing gains—an event that became self-reinforcing. Weakness in the markets spilled over to the real economy where the impact of lower wealth and increased uncertainty more than offset the benefit of lower market interest rates.

As a result, we have lowered our real GDP forecast to 3.25% from 3.5%, and believe the risks are still weighted to the downside. We are leaving our 2011 real GDP forecast unchanged at 3%, but we should warn readers that there is a fair amount of ambiguity around this forecast because of unclear fiscal and regulatory policies and the risk that fragile confidence could buckle under increased pressure from economic uncertainty. Still, should subsequent revisions become necessary, we highly doubt that our GDP forecasts will end up below 3% for 2010 and 2% for 2011.

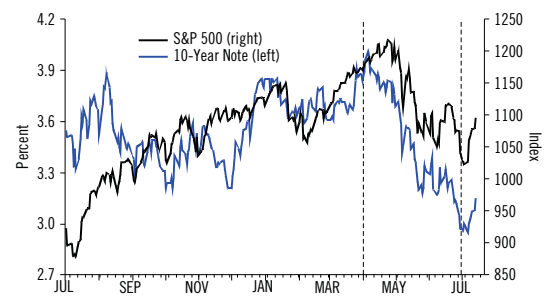
Our GDP forecasts already factor in many of the fears du jour such as severe state and local budget constraints, tightening federal fiscal policy, weak nonresidential real estate spending, a declining lift from inventory restocking, and an expected slowdown in export growth. Thus, we

do not believe that these particular headwinds will ground the economy. We are concerned, though, that increased hype in the media about an impending double dip will further weigh on animal spirits, which have already been damaged by tighter financial conditions.

We are carefully monitoring the labor market because it is the cornerstone of this recovery. We are disappointed that the labor market lost strength as the second quarter progressed, but we are still heartened by the level of improvement. The strong advances in private payrolls in March and April were accompanied by healthy gains in the average workweek and average hourly earnings, and this combination led to very strong gains in labor income. In May, private payroll growth was dis-

Ten-Year Treasury Yield vs. S&P 500 Index

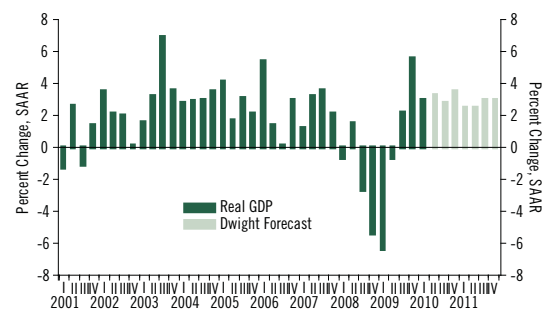
Investors Pulled in Their Horns During the Second Quarter



Source: Global Insight

Real GDP: Actual versus Forecast

Real GDP Growth Should Average 3.25% in 2010 and 3% in 2011



Source: Global Insight and DAMCO

appointing, but gains in the workweek and hourly earnings were sufficient to provide another strong lift to personal income. June employment data were a disappointment, though, and point to weak labor income for the month.

We are inclined to believe that weakness in June will give way to strength in coming months, so we are maintaining our 1.5% nonfarm payroll annual growth forecast. During the second half of the year, we expect monthly payroll gains to be near 200,000 on average. Such gains should generate a sufficient tailwind to plow through the headwinds listed above. The unemployment rate will probably remain high despite the increase in hiring because labor force growth should also accelerate. We look for a roughly 9.5% unemployment rate at the end of

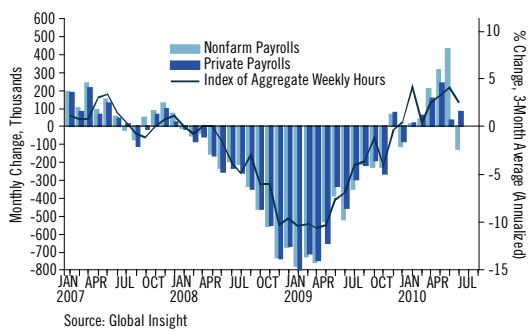
this year and 8.5% at the end of next year.

Politicians remain highly concerned about the sorry state of the labor market, and we expect Congress will ultimately provide more assistance even if extended unemployment benefits are not approved by the Senate in the near term. We are impressed, though, by newfound fiscal rectitude by many Congressmen. We think it would be a mistake to tighten fiscal policy too aggressively at this point in the cycle, but we would heartedly welcome reform efforts aimed at tackling our longer-term fiscal problems. Indeed, fiscal austerity without reform would be a huge disappointment.

Public authorities appear to be aware of the risks facing the economy, and they will most likely renew efforts to support the economy if it stumbles. The Fed will probably be reluctant to re-engage in quantitative easing by purchasing more long-term bonds, but we think fiscal policy is the better tool for the job anyway. At this point, fiscal policy is partially constrained by large budget deficits, but Treasury investors remain willing to supply capital at very low rates so there is still time on the clock. To keep the clock from running out, we think it behooves Washington to demonstrate a willingness and ability to address our long-term structural budget problem at the same time that they keep the cushions adequately plumped under the economy's rump. ■

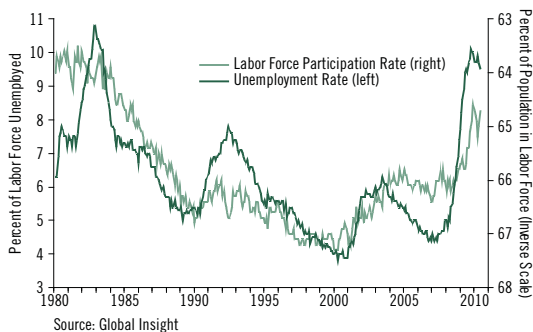
Nonfarm Payrolls

Rising Trend for Private Hours Worked Slowed in June



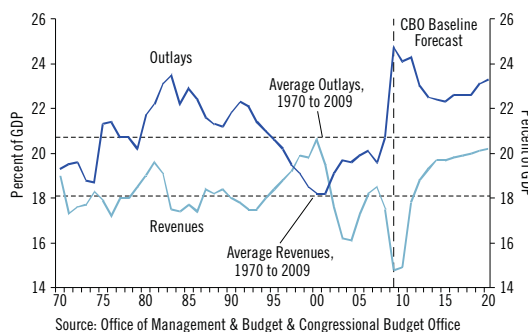
Unemployment Rate & Participation Rate

How Quickly Will the Participation Rate Improve in 2010?



Federal Government Revenues & Outlays

The Government Is Becoming Appreciably Larger



Fixed Income Sector Review, continued from the front page

▶ We believe that further upside in the Treasury market is limited and that the risk/reward relationship favors higher rates in the second half of the year. We have positioned our portfolios modestly shorter than their duration benchmarks and have underweighted Treasuries in favor of high-grade spread product. We continue to believe that the economy is in a sustainable recovery, and that explosive growth in the monetary base and the nation's fiscal deficits will set the stage for steadily rising interest rates in the medium to longer term.

CORPORATE CREDIT

Investment-Grade Corporates: Investment-grade corporates posted a positive total return of 3.42% in the second quarter, bringing the year-to-date total return to 5.79%. The sector trailed duration-matched U.S. Treasuries for the quarter by 225 basis points, reversing the first quarter's outperformance and bringing year-to-date excess returns to -1.10%.

Investors reduced risk in May as several events added uncertainty to a psychologically fragile market. In addition to the general unease about the strength of the economic recovery, factors weighing

on sentiment included concerns regarding European sovereign default risk, uncertainty surrounding the pending financial regulatory overhaul, potential litigation risk for financial issuers, and the fallout from the oil spill in the Gulf of Mexico.

As a result, the average yield on investment-grade corporate bonds ended the quarter 193 basis points above Treasury yields, which was 43 basis points wider than its level on March 31. All three major sectors, industrials, financials and utilities, posted negative excess returns relative to Treasuries. Industrials were the most resilient at -1.80%, while financials and utilities came in at -2.96% and -2.07%, respectively. Aerospace defense and diversified manufacturing were the only two subsectors able to muster positive excess returns. The subsectors with the largest negative excess returns were those with the greatest exposure to the Gulf spill. Oil field services registered -9.72% and independent energy posted -6.36%.

Even in a slower growth environment, we believe corporate spreads are compelling as they offer both an attractive yield relative to other investment-grade sectors and the potential for tightening. Given the current uncertainty in the market, sector rotation

Dwight Sector Specialists

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Investment-Grade Corporates



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High-Yield Corporates



Keith McCarthy
Municipal Bonds



Steve Clancy
Mortgage-Backed Securities



Jason Golder
Commercial Mortgage-Backed Securities



Kati Birmingham
Asset-Backed Securities



Eric Hiatt, CFA
Cash

will continue to be an important driver of performance during the second half. Therefore, we will maintain our overweight positioning versus our benchmarks while continuing to closely monitor developments in the market that could impact the relative attractiveness of corporate credit.

High Yield Corporates: The high yield market had a rough second quarter as market participants reduced risk amid heightened uncertainty in Europe's southern periphery. In contrast to the first quarter, high yield lagged duration-matched Treasuries by 386 basis points and now trails duration-matched Treasuries by 36 basis points for the year. The total return was a modestly negative 0.11%, which lowered the year-to-date return to 4.51%—on pace for a coupon-like total return for 2010.

In many ways, the market's second quarter performance was diametrically opposed to that of the first in terms of performance, issuance, and fund flows. While the primary market remained open, the pace of issuance slowed markedly from the frenetic pace of the first quarter. Moreover, spreads returned to year-end 2009 levels (700 basis points) erasing the earlier tightening. Lastly, investors withdrew approximately \$3 billion from high yield mutual funds, countering the market-supporting inflows from the first quarter. Continuing in the spirit of the "opposites" theme, the BB credit tier outperformed the B and CCC credit tiers as investors modified their portfolios away from riskier names toward higher quality, more defensive credits. All told, company fundamentals remain on the positive trajectory of recovery as we continue to see incremental top-line revenue growth and cash generation. In addition, as companies focus on extending maturities and managing their capital structures, continued access to the primary market coupled with trend economic growth is critical to balance sheet improvement.

Despite recent volatility and spread widening, we believe that the high yield market remains attractive given our constructive economic view. We retain our high quality bias as CCC spreads are not compensatory on a risk-adjusted basis because of

elevated jump-to-default risk. We expect to continue to selectively participate in the primary market given attractive pricing and deal structure. Lastly, we will continue to actively reassess our overall strategy pending changes in our economic view and in the quality and depth of the primary market.

Municipal Bonds: The total return for the Barclays Capital Municipal Bond Index for the second quarter of 2010 was a positive 2.03%, which brings the year-to-date total return to 3.31%. Once again, top-quality AAA and AA municipals outperformed lower rated A and BBB munis. New issue volume totaled approximately \$96 billion bringing the first half total to \$203 billion, which is 3.92% ahead of last year's pace. We expect issuance to surpass 2009 volume of \$409 billion.

In the taxable municipal market, spreads have been trending wider mainly due to anxiety over state fiscal deficits, unfunded pension liabilities, and prognostications in the press around the potential for increased municipal defaults. Taxable spreads widened 74 basis points in the quarter from their 2010 tight, and over this same period U.S. Treasury yields have declined 78 basis points. The total return for the Barclays Capital Taxable Municipal Bond Index was 4.64% and 8.21% for the second quarter and year-to-date periods, respectively.

While we acknowledge that states and local governments continue to struggle with severe fiscal pressures (46 states face a combined budget shortfall of \$115 billion for the fiscal year-ending June 2011), we continue to believe that market concerns are overblown, with states having a wide range of fiscal management tools. Although there are some notable exceptions, by the time the 2011 fiscal year began on July 1, 2010, most states had passed balanced budgets as required by state law using the usual assortment of tools at their disposal. These include reduced spending, increased fees and taxes, and an assortment of one-shot solutions designed to get them through the current economic environment. While the fiscal environment will remain difficult for some

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► time, we expect the vast majority of states to successfully manage their way through their challenges.

STRUCTURED PRODUCT

Mortgage-Backed Securities: The mortgage-backed securities (MBS) sector returned 2.87% in the second quarter of 2010. On a duration-adjusted basis, MBS outperformed U.S. Treasuries by 1 basis point. Mortgages reached record-high dollar prices this quarter, which is especially surprising given the absolute level of U.S. Treasuries.

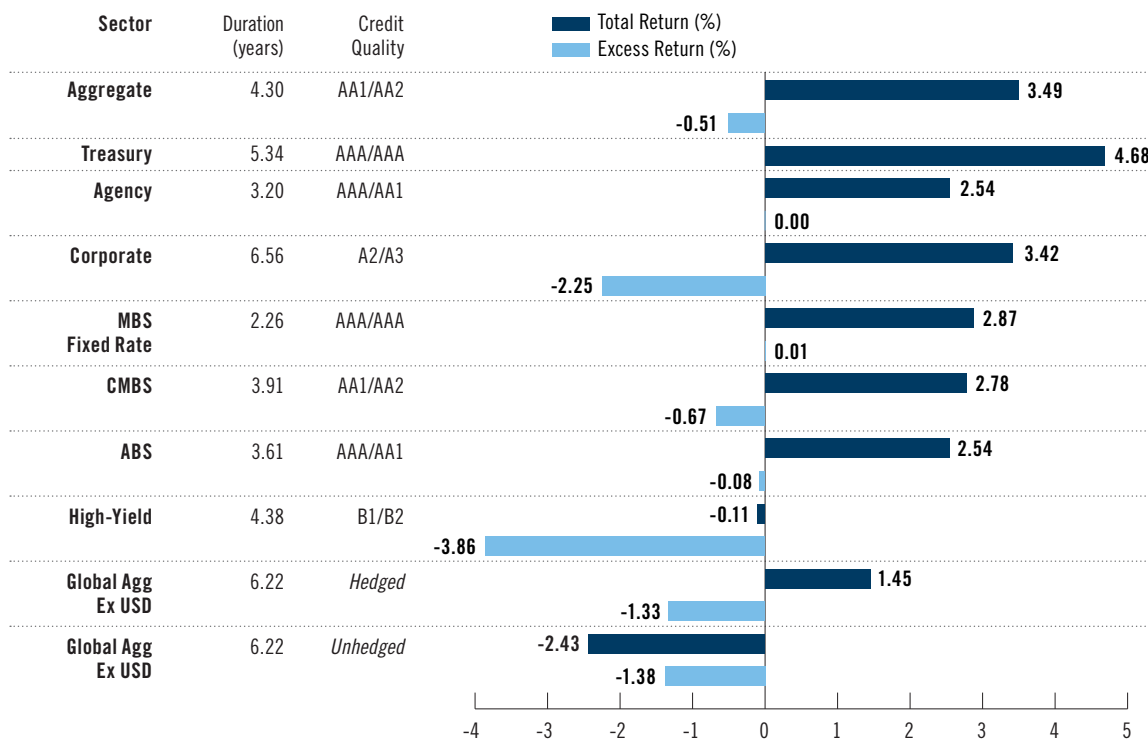
The major event of the quarter was the fallout from Fannie and Freddie buying out delinquent loans. Post buyouts, higher coupon speeds slowed markedly causing them to outperform lower coupons on a duration-adjusted basis. Ginnie Maes also fared well

as investors fled the buyouts in conventional mortgages. Investors also favored the improved delinquency disclosure of Ginnie Mae securities, which was enhanced to a security-level basis.

We believe the Fed is divided when it comes to asset sales. Selling its MBS holdings would placate the regional presidents and reinforce the Federal Reserve's independence. We think the Fed will announce a small selling program sometime during the fourth quarter of this year, which will give the market clarity and the FOMC the ability to judge the impact. If the program is received well, we would expect the Fed to produce a regular schedule for selling off the rest of its holdings.

Non-agency mortgage prices showed some weakness this quarter. While AAA-rated bonds

Second Quarter 2010 Sector Statistics*



*Source: Barclays Capital Indices, POINT. ©2010 Barclays Capital Inc. Used with permission. POINT is a registered trademark of Barclays Capital Inc. 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.

continued to show fervent demand, prices on below investment-grade bonds fell about 3–5 percentage points. Ratings downgrades pushed prices lower as fewer investors can purchase lower-rated bonds. Investors also became nervous about taking on more risk with the revelation of the crisis in Europe. Prices have since found some stability and we think these securities offer good relative value and will perform well.

We maintained our underweight position in agency MBS this quarter. We expect that mortgage valuations will bounce around for the better part of the year, but that on average they will cheapen.

Commercial Mortgage-Backed Securities: The commercial mortgage-backed securities (CMBS) sector was somewhat muted in the second quarter, delivering a total return of 2.78% but underperforming U.S. Treasuries by 67 basis points on a duration-adjusted basis.

Real money investors remained largely on the sidelines for the second quarter, unable to discern a definitive direction for the commercial real estate sector. While fundamentals such as lease rates, occupancy levels, and CMBS delinquencies continued to deteriorate, the pace of deterioration began to slow and the wide spreads relative to other sectors largely compensated investors for the fundamental weakness. The elephant in the room was macroeconomic uncertainty. While commercial real estate seemed poised to find a bottom in terms of price declines and regain some measure of strength, the specter of continued high unemployment and lowered economic growth expectations provided a headwind to any rebound, keeping the bulls at bay.

From a technical standpoint, buyers were able to absorb a lower volume of bonds for sale but there were few investors out actively looking for bonds or attempting to extend their long positions. Broker-dealer inventories were full with 2006–2007 vintage deals that have been perceived to carry more risk. There was some modest new issuance during the quarter, but new supply remained sparse. We saw a large multi-borrower conduit deal and a very high

quality single borrower deal come to market, both of which were well received.

We continue to favor an overweight to the CMBS sector to take advantage of the positive carry and the relative value it provides. We maintain a bias toward earlier vintage deals and bonds at the top of the capital structure to mitigate the risk associated with deteriorating fundamentals or a meaningful backup in spreads for credits that may have appreciated too far for their risk profile.

Asset-Backed Securities: The asset-backed securities (ABS) sector of the Barclays Capital Aggregate Index posted a total return of 2.54% during the second quarter of 2010. On a duration-adjusted basis, ABS underperformed Treasuries by 8 basis points. Rate reduction bonds were the best performer in the ABS sector, posting a total return of 3.23%. We experienced some light volatility surrounding the news from Greece, but the sector was well insulated from any significant weakness.

AAA consumer ABS bonds sustained their rally during the second quarter. The strong demand of high-quality short-duration assets and limited supply technicals should keep spreads flat or potentially tighter for the remainder of the year.

The improved earnings of ABS servicers along with encouraging economic news for the consumer have been positive for performance and spreads. Credit fundamentals for consumer loans have been steadily improving over the course of the year. Delinquency rates, loss severities, and total net losses have continued to decrease. This should also support the positive trend in spread tightening we have seen thus far in 2010.

The home equity market had a relatively benign quarter compared to many other fixed income sectors. Investors continued to favor shorter, current-pay subprime bonds to reinvest cash at attractive loss-adjusted yields over longer, less credit-enhanced paper. Subprime collateral performance showed ongoing signs of stabilization over the last several months with late-stage delinquencies

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- ▶ slowing and roll rates improving. A good deal of this improvement in fundamentals has been derived from increased servicer activity in making loan modifications and working through the backlog of foreclosed inventory.

We will opportunistically reinvest in the consumer sector, concentrating on top-tier, AAA-rated classes with low spread duration. We are comfortable with our current subprime positioning as the outlook for credit fundamentals continues to improve.

CASH

U.S. commercial paper outstanding has fallen 10.75% since starting the year to \$1.03 trillion. The decline was led by a drop in asset-backed commercial paper (ABCP) and domestic financial commercial paper which declined 12% and 19%, respectively, over the period. The declines were partially offset by gains in both tier-2 and non-financial issuance.

Of the prevailing trends in the commercial paper market, the decline in ABCP is unquestionably the most remarkable. Since the peak of \$1.2 trillion in the summer of 2007, the sector has declined 67% through mid-year 2010. While demand has been constrained in the wake of the credit crisis, a portion of the decline

is due to looming regulatory changes such as FAS 166 and 167, whereby bank sponsors are moving to bring assets onto their balance sheets. This has had the added effect of entities being forced to either consolidate or wind down various programs.

Sovereign risk has been a large driver behind asset flows in the money markets as the situation in Greece and the broader EU has left global investors on edge. Foreign banks are typically large borrowers in the U.S. money market, although names with perceived headline risk, such as Spanish and Italian banks, have had more difficulty funding lately. In contrast, high-quality Australian, Canadian, and Nordic banks are trading well inside of 3 months where they have been funding at sub-LIBOR levels.

After spiking in early May, USD LIBOR has reached a temporary plateau as 3-month USD LIBOR hovers in the 0.53% area. Helping to ease the strains in the interbank funding market has been an extension of ECB refinancing operations, which provides temporary credit to eurozone banks. This has helped keep the spread between LIBOR and the overnight indexed swap rate (or the LIBOR-OIS spread, a closely watched measure of credit availability) in the low 30 basis point range after tripling at the start of May. ■

International Bond Market Update, continued from page 3

- ▶ The Chinese government formally abandoned the currency peg, and the initial market reaction to predict a rapid appreciation of the renminbi versus the dollar was overdone and way too optimistic. We believe a carefully orchestrated move of 5% or less over a 12-month time horizon is most likely. The momentum of the Chinese economy is fading after months of double-digit growth. The tightening action by the Chinese central bank targeted an overheating property market and a worrisome trend in inflation. Growth was further impacted by a general slowdown in economic activity around the globe.

Low historical yields in the safe-haven markets like the United States and Germany leave little

margin for error; however, the tenuous state of public sector finances favors quality and we believe that rates will stay low in Europe for some time. We see no real threat of inflationary pressures in most developed nations and therefore continue to like selective European sovereign markets and high-grade corporate bonds hedged back into U.S. dollars. We maintain our long-held view that the euro will resume its downtrend and that the recent relief rally represents a sell opportunity. We expect new lows by year-end and would not rule out parity to the U.S. dollar. We expect the yen to depreciate versus the dollar, weakening to levels in the mid-nineties or around ¥100/\$ by year-end. ■