DWIGHT
ASSET MANAGEMENT COMPANY

ECONOMIC & BOND MARKET
QUARTERLY UPDATE

THIRD QUARTER 2009

Money Market Fund Industry Awaits Reform

The financial crisis has stimulated dramatic changes across many facets of the securities markets in the past year, and the money market fund industry is no exception. This once-sleepy sector of the market was rattled by previously unimaginable spread widening and liquidity strains, culminating with the Reserve Primary Fund, a $64.8 billion money market mutual fund, "breaking the buck" in the wake of the Lehman Brothers bankruptcy last fall (meaning its net asset value fell below $1 per share). Despite the volatility, money market funds have otherwise proved to be generally resilient, with U.S. money market fund cash balances rising well above the 5-year average balance of $2.6 trillion to $3.5 trillion in 2009. Nevertheless, increasing concern regarding the safety of these funds during extreme market conditions has precipitated regulatory action within the asset class.

The government support programs implemented to stabilize the short-term markets have so far proved to be largely successful, but as markets continue to heal, some of these programs are beginning to expire. The Temporary Guarantee Program for Money Market Funds, which provided fund companies with temporary $1 net asset value insurance to prevent another Reserve Primary Fund–type event, expired in September. According to Treasury Secretary Geithner, the program had served its intended purpose of bringing stability to the industry "during the market disruptions last fall." Indeed, such programs have helped the short-term market regain its footing, but long-term changes still loom on the horizon for money market funds.

John Donohue
Head of Cash Management

In December, the President's Working Group on Financial Markets (PWG) will propose changes to rule 2a–7, which governs

continued on page 2

Fixed Income Sector Review

GOVERNMENT-RELATED DEBT

U.S. Treasuries and other government-related debt securities fared well in the third quarter as liquidity-fueled demand led to declining inflation and liquidity risk premiums across asset classes. Despite large increases in Treasury issuance, demand from retail and institutional investors proved robust as short-term borrowing rates hovered just above 0% and issuance in non-Treasury sectors remained low. The Fed also continued to support the market with its Treasury purchase program, buying over $100 billion during the quarter. According to Barclays Capital Aggregate Index data, Treasuries returned 2.10% for the period, with the yield on 10-year notes declining 33 basis points. Treasury Inflation-Protected Securities (TIPS) also performed well, returning 3.08% as 5- and 10-year real yields declined 28 and 23 basis points, respectively, and inflation breakevens ranged from unchanged to more than 30 basis points lower across the curve.

Agency debt continued to benefit from negative net issuance, as well as from the ongoing Fed purchase program through which the Fed purchased approximately $34 billion in the third quarter, bringing its total purchases to over $130 billion since the program began in December 2008. Callable agencies also saw strong demand as investors viewed the sector as a cheap alternative to agency collateralized mortgage obligations (CMOs), especially as Fed rhetoric reassured buyers that accommodative policy would remain in place for an extended period and keep short-end volatility low. According to index data compiled by Barclays Capital, agencies returned 2.02% for the period, outperforming Treasuries by 58

continued on page 6

Money Market Fund Industry Awaits Reform, continued from the front page

the ubiquitous $3.5 trillion money market fund industry. These changes are expected to include restrictions on certain investments, a reduction in the average maturity of underlying securities, additional gating flexibility to mitigate "run-on-the-fund" risks, and new stipulations concerning fund liquidity profiles. The upcoming changes will not only alter the structure and improve the safety of money market funds, but they will also impact money market fund performance. Under the new regime, money market fund yields will more closely track the federal funds rate because alpha-generating strategies, such as overweighting floating rate notes and maintaining longer durations, will be constrained.

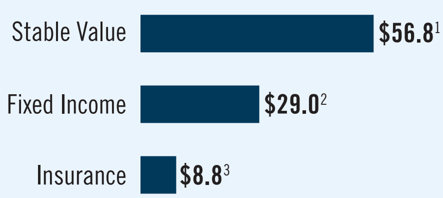
Meanwhile, the number of commercial paper issuers has decreased as a result of the economic downturn, and banking institutions with alternative funding mechanisms are less inclined to borrow. While this has led to a dramatic improvement in liquidity, it has also resulted in historically low money market yields—and investors have been keen to search for alternative cash solutions in response. Consequently, customizable separate accounts have increased in popularity. Separate accounts offer several benefits, including flexible investment guidelines, customized reports, enhanced liquidity management, and the elimination of shareholder concentration risks. Accordingly, these vehicles could potentially add between 15 and 50 basis points in excess return over a typical money market fund through greater investment guideline flexibility and lower fees (we estimate the average separate account fee for a money market fund to be between 12 and 15 basis points, compared to an average of 20 basis points for the institutional share class of a typical money market fund).

In the aftermath of the financial crisis, capital preservation and liquidity are at the forefront for money market investors. Financial markets have become more sophisticated, and when tested in 2008, rule 2a–7 parameters have proved to be antiquated. We believe that eliminating the rule's nebulous characteristics will make money market funds more secure and that implementing more stringent investment guidelines will have a positive impact on the industry. Forthcoming changes and historically low yields will undoubtedly prompt market participants to take another look at how they manage their short-term assets. Returning to more conventional means of short-term asset management, however, should improve money market investors' ability to achieve their capital preservation and liquidity objectives. Moreover, customizable separate account vehicles offer investors an opportunity to add value to their short-term investments, notwithstanding the aforementioned challenges. We continue to monitor this closely, and will keep you apprised of new developments in the money market sector as the PWG finalizes its plans in December. ■

Dwight Asset Management Company LLC
Total Assets as of 9/30/09:

$69.3 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 8/31/09.

International Bond Market Update

The calendar for global bond issuance continued to be super-sized during the third quarter. New issues were received exceptionally well whether the borrowers were governments or corporations, despite fears to the contrary. Investment-grade and high-yield corporate bond spreads tightened to pre–Lehman Brothers bankruptcy levels both here and abroad, with high-beta names in particular finding a strong bid. The placement of new paper was undoubtedly helped by investors previously parked in money market funds as they returned to riskier assets in fear of being left behind.

Less than a decade after what former Fed Chairman Alan Greenspan once referred to as the "irrational exuberance" that preceded the dotcom bubble and just two years after the implosion of excessive housing speculation, the market appears to be on steroids, fuelled by historically low funding rates. Could we be witnessing the formation of the next bubble—this time in the bond markets—before our eyes? Over the past twelve months governments around the world have launched record-setting stimulus programs, which were supplemented by major central banks providing unprecedented global liquidity, in an effort to unlock the credit markets and fight the recession. The initial scarcity of cash led to a massive and forced deleveraging of consumers and financial institutions alike, threatening global economic equilibrium at its core.

But times have since changed and, courtesy of the decisive actions from governments and central banks, global markets are now awash in cash. Not only have we witnessed a stunning turnaround in equity markets around the globe, but the feared flood of new issuance in the fixed income markets has been met by an insatiable appetite from investors. Could the same measures that were designed to unlock financial markets be contributing to the next bubble, with central banks serving as willing accomplices in the next potential crisis?

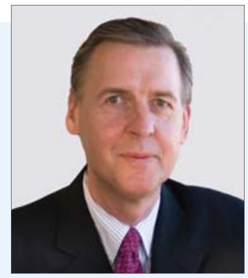
For the first time since the early nineties, U.S. dollar–denominated LIBOR funding costs are lower than those denominated in Japanese yen. The U.S. dollar is suddenly among the favorite carry-trade currencies, which in return elevates its risk of spiraling lower. The traditional strong-dollar policy of the United States has long been abandoned—a trend that began well before the new administration took office. We cannot blame the current administration for trying to export its way out of this latest crisis, though. Our northern neighbors in Canada are increasingly concerned about their appreciating currency, as are the Europeans and the Japanese. While the weak U.S. dollar provides welcome relief to those U.S. companies that are dependent on exports, it also puts the rest of the world at a competitive disadvantage.

The weaker U.S. currency only adds fuel to the fire of a more broad-based discussion: the status of the U.S. dollar's role as the number-one reserve currency in the world. As we have pointed out in the past, the replacement of the U.S. dollar as the world reserve currency, while neither likely nor practical in the short term, could have potentially catastrophic consequences for the United States' ability to finance its mushrooming budget deficit.

There are many questions but few answers at this time. The fragile nature of the global economic recovery might give the investment community some reprieve, but eventually the exit strategy of leading central banks will become an unpleasant reality. During prior bubbles, the Federal Reserve and its peers have acted decisively in counteracting a potential crisis, but they have historically struggled when the time came to withdraw excess liquidity. Whether the global central banks will be able to effectively neutralize their massive liquidity injections without pricking another bubble in the bond markets remains to be seen.

We are increasingly concerned that the tremendous year-to-date performance of high-beta assets will motivate investors to take profits on their holdings ahead of year-end. Any pronounced setback in

continued on page 10



Peter Vutz
Head of Corporates International, Non-Dollar

Economic Update

Jane Caron, CFA
Chief Economic Strategist

Following four consecutive quarters of declining economic output, real GDP is set to expand by roughly 3% on average for the final two quarters of 2009. Just about all of this growth can be traced back to various fiscal and monetary policy support programs, but under their protective cast the economy is in fact healing. In 2010, the economy will still be convalescing, but real GDP growth of 2.5–3% seems likely. We are on the lookout, however, for potential shocks that could set the recovery process back. Should that happen, we expect policymakers to administer additional stimulus.

The list of potential shocks is long, but the one that we spend the most time thinking about is a policy mistake. Our concern is not based on low regard for the skill sets of key macro policymakers, but the realism that accurate forecasting near big inflection points is almost impossible. Indeed, the range of forecasts on Bloomberg for 2010 real GDP growth is -0.1% to 4.0%. Similarly, FOMC-member 2010 GDP growth projections range from 0.8% to 4.0%. These varied opinions will be a challenge for consensus-style decision making. The likely outcome is that monetary policy will be tightened either too quickly or too slowly. A Goldilocks outcome is unlikely.

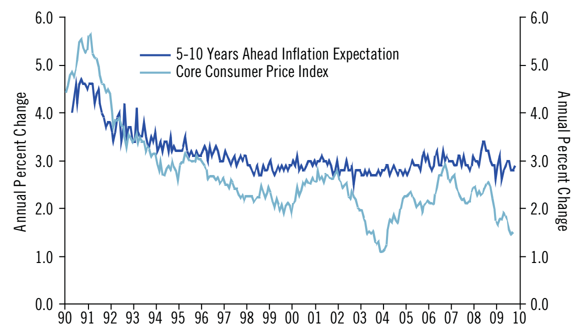
One thing that most economists seem to agree on is that the outlook for inflation is troubling. In the near term, disinflation is expected to prevail because of the extensive amount of excess capacity at home and abroad. In 2010, we expect core consumer inflation to slip below 1% and possibly approach 0%. This is not a pernicious outcome as long as long-term inflation expectations do not react. Fortunately, it takes a lot of force to shift long-term inflation expectations, as demonstrated by their persistently narrow range during the crisis. Still, not since the 1930s have we experienced such a sharp rise in unemployment coincident with very low core inflation rates. Thus, there is a danger that a double-dip scenario could spark a wage-price negative feedback loop that leads to deflation. Having witnessed the destruction caused by house price deflation, we do not want to entertain the thought of economy-wide deflation.

Nor do members of the Federal Open Market Committee (FOMC) or any other person charged with overseeing the economy. This is why there has been an unprecedented effort to halt the turmoil in the financial markets and re-inflate the economy. The fact that the economy is now in recovery mode is a great relief—even if the recovery is likely to be characterized by slow growth and high unemployment. In fact, a slow, sustained recovery is better than a rapid recovery because it will allow the Fed more time to calibrate monetary policy.

Removing the extraordinary degree of monetary accommodation will ideally be accomplished over an extended period because a rapid adjustment could send the economy into a tailspin. During 2010, we expect the FOMC to take some slack out

University of Michigan Inflation Survey

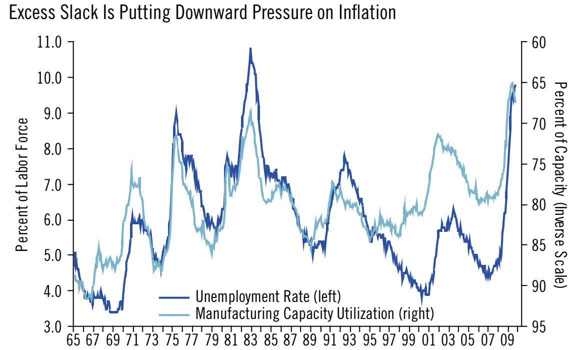
Long-Term Inflation Expectations Are Still Contained



Source: Global Insight

Unemployment & Capacity Utilization Rates

Excess Slack Is Putting Downward Pressure on Inflation



Source: Global Insight

of the reins, but we do not expect them to pull back on the bit. By this we mean that the Fed will seek to mop up excessive liquidity without stifling credit creation. Today, the Federal Reserve's balance sheet is about $2.2 trillion, and it may reach $2.5 trillion early next year. In September 2008, just prior to the failure of Lehman Brothers, it was about $900 billion. Similarly, excess reserves are currently $850 billion compared to about $50 billion in September 2008. As the Fed's market liquidity programs are reduced or canceled, excess reserves will be reduced, but they will still exceed $500 billion. To extinguish additional reserves, the Fed will need to engage in asset sales. We highly doubt that the Fed will seek to do this before it is abundantly clear that labor and capacity utilization rates are recovering and deflation risks are receding. Instead, we expect the Fed to take some of the slack out of the reins by lending out (reverse repo) some of the bonds it holds and otherwise encouraging banks to commit to keeping excess reserves at the Fed. Only if market conditions are conducive do we expect the Fed to raise the federal funds rate by paying a higher interest rate on reserves.

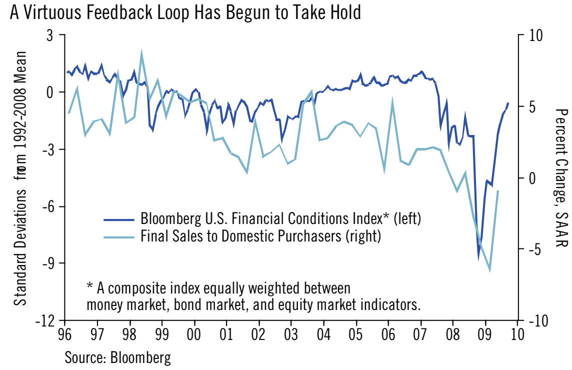
Historically, explosive growth in the monetary base has been associated with a surge in inflation. The reason inflation has continued to fall is because the velocity of money has collapsed. This is evidenced by the fact that M2 money supply has not risen simultaneously with the surge in excess reserves, which are part of the monetary base. If the velocity of money—the speed with which money circulates through the economy—were to recover too quickly, the Fed would need to dampen it or shrink the monetary base. Those fearing rapid inflation, however, are worried that the Fed will not act quickly enough or that the FOMC's actions will not have the desired effect, given they will be working with many previously untried tools.

The good news is that we are still a long ways away from the point where inflation will become a threat, so policymakers have plenty of scope to remain accommodative in 2010. It bodes well for economic growth next year that recoveries in the financial markets and global economies are becoming mutually reinforcing. Indeed, the Bloomberg Financial Conditions Index for the United States is now just 0.6 standard deviations below the neutral level, compared to 8.5 standard deviations below normal a year ago. Granted, credit creation will remain muted because commercial banks are still reluctant to lend and the shadow banking system is dysfunctional, but the credit crunch is clearly easing.

Also pointing to a recovery is the index of leading economic indicators, which has risen for six consecutive months, as has the ratio of the coincident to lagging indices, itself a leading indicator. Meanwhile, the Institute for Supply Management's purchasing manager indices have rebounded to levels consistent with expansion in the manufacturing, construction, and service sectors. A significant portion of this growth reflects the need to slow the pace of inventory destocking following excessively sharp cutbacks, but inventory rebalancing is expected to help generate endogenous growth by putting people back to work. Generating increased labor income is really the key to not only a sustained recovery but also a successful transition from assisted living to independence. At this time, the labor market is still far from fulfilling this obligation, but we believe it will in 2010… barring an exogenous shock or a disastrous policy mistake. ■

Financial Conditions & Domestic Demand

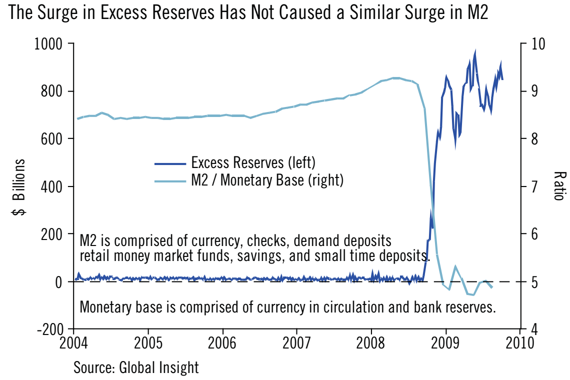
A Virtuous Feedback Loop Has Begun to Take Hold



Source: Bloomberg

Federal Reserve Banks: Excess Reserves

The Surge in Excess Reserves Has Not Caused a Similar Surge in M2



Source: Global Insight

Fixed Income Sector Review, *continued from the front page*

As market liquidity and spread levels continue to normalize, issuer-specific risk should overtake systemic risk as the key driver of returns.

basis points on a duration-adjusted basis.

Government-guaranteed bank debt, including securities issued under the FDIC's Temporary Liquidity Guarantee Program (TLGP), followed the performance of agencies and tightened by an average of 10 basis points over Treasuries producing 41 basis points of excess return. Supranational and sovereign issues also rallied on strong demand from foreign central banks and from domestic investors seeking a high-quality alternative to agencies and corporate credit. Sovereigns, aided by the ongoing global economic recovery, tightened by 53 basis points on average and handed investors 384 basis points of excess return. Supranationals, meanwhile, produced 107 basis points of excess return, ending the period at 44 basis points over Treasuries.

We believe that agencies and other U.S. government-backed debt issues are fully valued at current spreads and expect additional upside to be limited to their incremental income over Treasuries. Nevertheless, we do not anticipate significant spread widening in the near term because investors remain flush with cash and high-grade alternatives are limited. Indeed, with new issuance in non-agency AAA-rated assets down sharply in recent years, investors are presented with few reinvestment options for their AAA portfolios. Longer term, however, with the future of the agencies still unresolved and the Fed's purchase program coming to an end, we believe that currently rich valuations will be vulnerable to a correction.

CORPORATES

Investment-Grade Corporates – The themes of the second quarter carried over into the third as investment-grade corporate bonds posted a total return of 8.12%, outperforming duration-matched Treasuries by 5.56%.

Increased economic clarity, a supportive supply and demand dynamic, and historically attractive valuations combined to drive corporate bonds to their second-best quarter on record. BBB-rated bonds outperformed A-rated bonds by 45 basis points during the quarter as investors acknowledged the increasing likelihood of a sustained recovery by increasing their risk appetites. This positive momentum was intensified by a dearth of new issue supply in the face of rejuvenated investor demand. Specifically, corporate bond maturity and coupon payments outpaced new issue supply by an average of about $23 billion per month, according to J.P. Morgan.

The Barclays Capital Credit Index started the quarter at an option-adjusted spread (OAS) of 273 basis points over Treasuries, only slightly below the pre–Lehman Brothers default level of 289 basis points. Spreads recovered through the widest levels of the 2001 recession (241 basis points) to end the quarter at an OAS of 198 basis points. Among the subsectors which outperformed were life insurance and building materials, while media cable and pharmaceuticals were notable laggards.

Throughout the quarter we maintained an overweight allocation to corporate bonds. Within this allocation we believe the banking subsector, with spreads almost 100 basis points in excess of industrials, offers compelling value. We have also started rotating out of utilities and into energy, which offers a better return profile in a sustained growth environment.

While an unemployment rate near 10% and an uptick in merger and acquisition activity gives us pause, we believe that corporate balance sheets remain strong. As market liquidity and spread levels continue to normalize, issuer-specific risk should overtake systemic risk as the key driver of returns. With improving fundamentals and a bullish demand outlook, we expect to maintain our overweight in the sector with an emphasis on credit selection.

High-Yield Corporates – The high-yield sector posted a strong 14.22% total return in the third quarter, outperforming duration-matched Treasuries by 12.33%. Outperformance was once again driven by the lowest credit tiers as CCCs returned 26.27%, while the combined BB and B sectors returned a more modest 11.19%. Overall, the high-yield market has tightened back to 764 basis points over Treasuries, the tightest it has been since June 2008.

The new issue market has fully reopened, giving investors greater confidence that companies can refinance debt in an orderly fashion. Despite concerns that a wave of new issuance could put pressure on the secondary market, the demand for paper remained strong throughout the quarter.

Defaults continued to increase, with the trailing 12-month default rate reaching 14%, including distressed exchanges. Because many of the defaults that occurred this year were well anticipated, they did not negatively impact the overall market. However, several companies have yet to fully address their over-leveraged capital structures and are likely to use either Chapter 11 or distressed exchanges to accomplish that end.

Despite increasing defaults and a tepid economic recovery, we believe that spreads remain compensatory, given identifiable risks. Nevertheless, spreads of lower-quality CCC names have rallied much more relative to higher-quality tiers and offer less compelling risk-adjusted return potential. As a result, we retain our high-quality bias. We also expect to continue to be active participants in the primary market given attractive pricing and deal structure, but will reassess our overall strategy pending changes in the quality and depth of the primary market.

Municipal Bonds – The Barclays Capital Municipal Bond Index returned 7.12% in the third quarter, bringing year-to-date performance to an astounding 14%, the highest return in almost 15 years. The sector outperformed the Barclays Capital U.S. Treasury Index by 502 basis points for the quarter and by 16.92% year-to-date.

Strong third-quarter performance was primarily driven by the increased saving rate, concerns about tax hikes amid record federal deficits, the ongoing supply and demand imbalance, and record-setting cash flows into municipal bond funds. The resounding success of the Build America Bond program has led to a significant reduction in tax-exempt issuance. Year-to-date Build America Bonds and taxable issuance has comprised approximately 17% of all municipal supply.

We continue to closely monitor the financial health of municipal issuers as states and local governments struggle with lower income and sales tax receipts. These declining revenues will cause municipalities to continue to make difficult budget cuts and likely raise taxes. History indicates that revenue collections are likely to continue deteriorating, as municipals tend to lag the overall economy by several quarters, possibly years after a recession ends. Nevertheless, we remain cautiously optimistic on the municipal sector due to the impending tax hikes and the fundamental strength of municipal credit structures.

STRUCTURED PRODUCT

Mortgage-Backed Securities – The mortgage-backed securities (MBS) sector returned 2.31% for the third quarter of 2009. On a duration-adjusted basis, MBS outperformed U.S. Treasuries by 112 basis points, marking the third straight quarter of strong relative performance for the sector.

The Fed continued its purchase program in the third quarter and announced that it would extend the program through the first quarter of 2010. These purchase efforts have been successful in maintaining low mortgage rates, and as a result the Fed now owns a majority of lower coupon bonds. In order to diversify, the Fed began purchasing higher coupon bonds and Ginnie Mae securities during the quarter—an action that has significantly changed the relative-value landscape for agency MBS.

Activity within the non-agency mortgage market was significant, as steady demand and a lack of supply caused prices to appreciate throughout the quarter. In particular, investors had a voracious appetite for seasoned, fixed rate bonds. While there may be little remaining upside for these bonds, the

continued on page 8

The Fed began purchasing higher coupon bonds and Ginnie Mae securities during the quarter—an action that has significantly changed the relative-value landscape for agency MBS.

Fixed Income Sector Review, *continued from page 7*

- Public-Private Investment Program (PPIP) should have a similar impact on pricing in other sectors of the non-agency market that are still undervalued.

The Fed has completed the bulk of its purchase program and we are concerned that mortgages will underperform without this large buyer in the market. As a result, we moved to an underweight position in agency MBS during the third quarter. Nevertheless, we believe that Fed purchases will fare well for Ginnie Mae performance in coming months and have thus tactically increased our Ginnie Mae holdings within our mortgage allocation. We continue to hold our core agency position in specific bonds with characteristics that shield them from large prepayments. In non-agency MBS, we have opportunistically sold positions that have appreciated significantly over the last two quarters. We have also sold a few seasoned bonds with nominal yields in the 4–5% range, and continue to hold those positions that we believe have more upside potential.

Commercial Mortgage-Backed Securities – The commercial mortgage-backed securities (CMBS) sector continued to rally in the third quarter, providing a total return of 12.70% and outperforming duration-matched Treasuries by 10.90%. The story was similar to that of the second quarter; the sector continued to sustain fundamental deterioration, but also experienced a strong technical bid as a result of general economic optimism, government stimulus, and attractive relative value.

The Term Asset-Backed Securities Loan Facility

Third Quarter 2009 Sector Statistics*

Sector	Duration (years)	Credit Quality	Total Return (%)	Excess Return (%)
Aggregate	4.40	AA1/AA2	3.74	1.98
Treasury	5.34	AAA/AAA	2.10	
Agency	3.37	AAA/AA1	2.02	0.58
Corporate	6.45	A2/A3	8.12	5.56
MBS Fixed Rate	2.93	AAA/AAA	2.31	1.12
CMBS	4.02	AAA/AA1	12.70	10.90
ABS	3.19	AAA/AA1	6.30	4.97
High-Yield	4.34	B1/B2	14.22	12.33
Global Agg Ex USD	5.99	*Hedged*	2.86	1.16
Global Agg Ex USD	5.99	*Unhedged*	7.85	1.30

*Source: Barclays Capital Indices, POINT. ©2009 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.

(TALF), which significantly benefited asset-backed securities earlier in the year, provided a strong boost to the CMBS sector. TALF and non-TALF investors scooped up eligible securities, driving spreads aggressively tighter. As the quarter wore on, the TALF-eligible securities stalled in a range of swaps plus 200–400 basis points. This compelled some investors to reach for yield among downgraded senior tranches, mezzanine and junior AAA bonds, floating rate CMBS, and interest-only securities that were not TALF-eligible. With the Public-Private Investment Program still on the horizon and an economic recovery in sight, investors increased their risk appetite in the third quarter and found the CMBS sector attractive relative to investment-grade corporates, asset-backed securities, and agency debt.

The CMBS sector continues to face uncertainty. Many investors have experienced solid returns for the year and may look to scale back trading activity, which will reduce liquidity in the fourth quarter. While we still favor the sector from a relative-value standpoint, we will monitor our overweight and continue to scale back on risk as we head into 2010. We will look to take advantage of short-term TALF and PPIP rallies, and reduce remaining portfolio volatility from ratings uncertainty and further fundamental deterioration.

Asset-Backed Securities – Relatively light supply and unrelenting demand led to further tightening of asset-backed securities (ABS) spreads during the third quarter. The ABS portion of the Barclays Capital Aggregate Index posted a total return of 6.30%, outperforming duration-matched Treasuries by 4.97% for the quarter.

Since the launch of TALF in March of 2009, spreads have compressed significantly within the ABS market. Initially, many of the newly issued deals were absorbed by participants of the TALF program, but in the third quarter, the larger allocation went to unlevered investors. Because TALF money managers were no longer able to achieve the desired levered yields at current spread levels, many took profits on their TALF holdings and began investing in more esoteric bonds and extending further out the maturity curve. These actions should continue to compress spreads on those types of assets going into year-end and signal a renewed sense of confidence in the ABS market. Moreover, the declining use of government support indicates that this market should eventually be able to stand on its own.

Heading into year-end, we expect to reduce our home equity exposure through amortization and select sales. We will be patient in our approach as we expect certain holdings to benefit from new demand arising from the launch of the Public-Private Investment Program.

While the outlook for the general health of the consumer is still bleak, we will opportunistically reinvest in the consumer sector as we believe these bonds provide a solid risk-adjusted yield. The enhanced credit support provided by issuers and overall tighter underwriting standards should reduce the credit risk that consumer ABS bonds are exposed to. Furthermore, we believe that the strong supply and demand differential in the ABS market should continue to support the rally that we have experienced to date in 2009.

CASH

With the Fed holding rates at record-low levels, nearly all corners of the credit market have seen a recent increase in prices that has resulted in lower risk premiums. In the money markets, supply constraints have made it more challenging for investors to find quality issuers that offer a palatable return on investment. After trading with negative yields last year, Treasury bill yields are once again hovering near 0%, with the 3-month bill closing out the month of September at 0.11%.

To be sure, the massive liquidity injection by global central banks has clearly served to supplement a large share of the private credit pullback. The Fed continues to purchase large volumes of Treasury,

continued on page 10

Fixed Income Sector Review, *continued from page 9*

agency, and agency-guaranteed mortgage-backed securities. The Fed has also been funding a number of facilities that provide support to the short-term credit markets in the wake of the disruption last fall (for example, the Commercial Paper Funding Facility [CPFF] and the Asset-Backed Commercial Paper Money Market Fund Liquidity Facility [AMLF]). As one might expect, however, these facilities have been relied upon to a lesser degree as markets have improved.

The number of commercial paper issuers has decreased, and banking institutions with alternative funding mechanisms are less inclined to borrow. While these factors have improved liquidity dramatically, they have also contributed to the historically low yields money market investors are now facing. As the economy continues to rebound and the Fed slowly drains liquidity from the market, we expect to see a gradual increase in short-end credit rates. We will continue to monitor the ability of money markets to operate efficiently in the evolving absence of Fed support and ahead of proposed changes to the regulatory framework that governs money market funds. ■

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Jason Golder
Commercial Mortgage-Backed Securities

Kati Birmingham
Asset-Backed Securities

Eric Hiatt, CFA
Cash

International Bond Market Update, *continued from page 3*

high-beta names could offer interesting opportunities to selectively increase our holdings. On a global basis, we continue to favor foreign-denominated debt relative to U.S. dollar–denominated debt. The recent weakness of the greenback has become even more pronounced because of the aforementioned carry trades, with the dollar losing 16% of its value relative to the euro since March 2009. The dollar is likely to resume a more orderly downward trend, with neither the United States nor the rest of the G10 showing the willingness or the ability to reverse the depreciation of the U.S. currency. ■

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