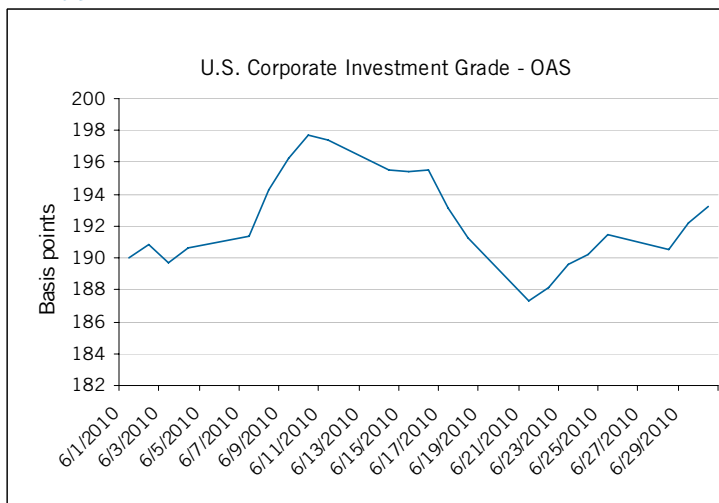


Is Muted Growth Less Than Zero?

June was another volatile month for Corporate credit (Exhibit 1). Spreads ended the month modestly wider, generating -9 basis points (bps) of excess returns for the Barclays Corporate Index driven mainly by the underperformance of the Energy sector (-249 bps excess return).

Exhibit 1



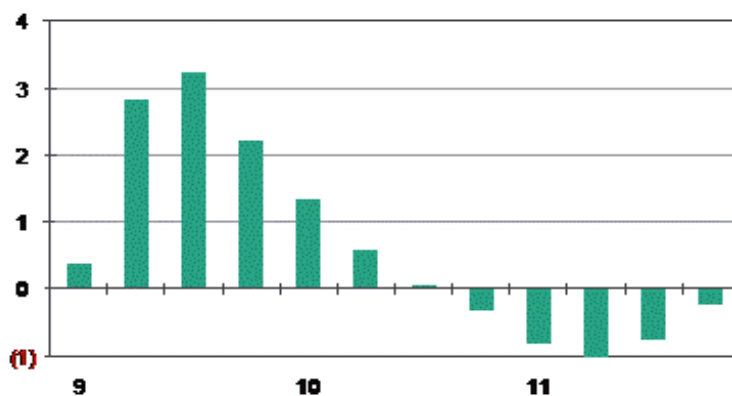
Source: Barclays

June failed to produce sufficient positive signs to allay concerns regarding the sustainability or strength of the domestic economic recovery. Early indicators are pointing to a slowdown in growth in the second half of the year. The question is how slow? We had believed growth would be modest this year, less than 3%, and vulnerable to a public to private sector handoff as stimulus spending waned (Exhibit 2). Since May, manufacturing has continued to expand, albeit at a slower pace, and private sector employment has disappointed, as private employers turn more cautious. We believe we may be at a point where inventory restocking has stalled and employers are willing

Exhibit 2: Stimulus contribution to real GDP growth (2009 – 2011)

Boost From the Stimulus Will Soon Begin to Fade

Contribution to real GDP growth, %



Source: Moody's Economy.com

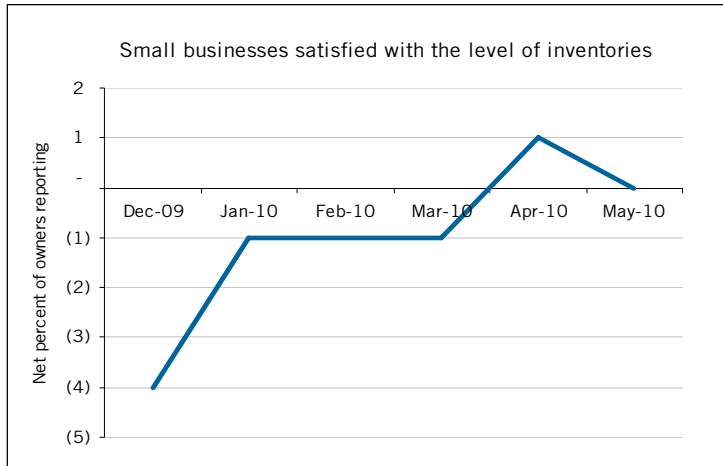


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to private sector handoff as stimulus spending waned (Exhibit 2). Since May, manufacturing has continued to expand, albeit at a slower pace, and private sector employment has disappointed, as private employers turn more cautious. We believe we may be at a point where inventory restocking has stalled and employers are willing

to replace but not build (Exhibit 3). Small business owners, as reflected by the

Exhibit 3



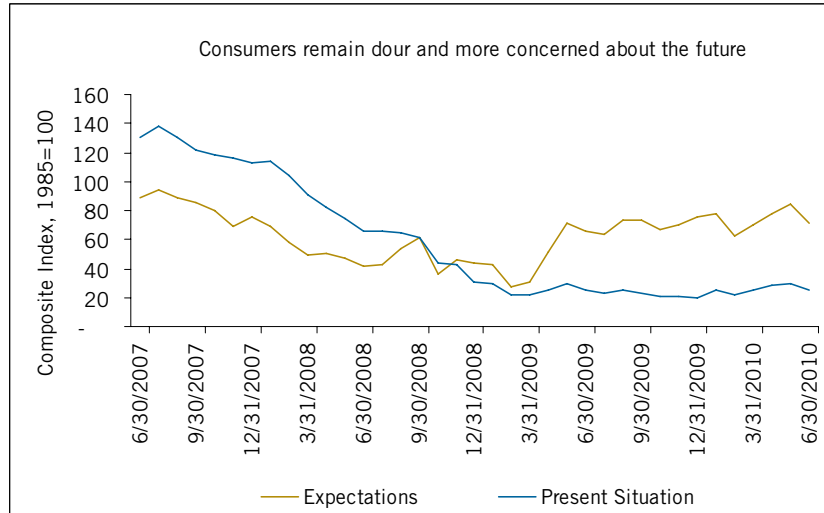
Source: National Federation of Independent Business; Bloomberg

National Federation of Independent Business (NFIB) survey, and large business CEOs, as reflected by the Business Roundtable survey, are concerned with the overall global economy, legislative policy, and new regulations and rules. Managers do not feel comfortable hiring new workers or spending capital when they are uncertain of the return on investment. Therefore,

jobs remain very difficult to source. We have been expecting jobless claims to fall below 400,000, a level that typically coincides with the end to payroll employment losses, and are still waiting. The jobs report released on July 2, 2010 was very weak, considering household employment declined sharply and both the workweek and average hourly earnings declined.

The high level of unemployed workers is being reflected in lower consumer confidence. The June Conference Board Index (Exhibit 4) reading disappointed (52.9 vs. a revised 62.7 in May) with a 16% drop in the expectations part of the index, a source of concern given the reliance on the consumer to solidify the recovery. As reflected in the present situation portion of the index, consumers recognize the obstacles they and their government face.

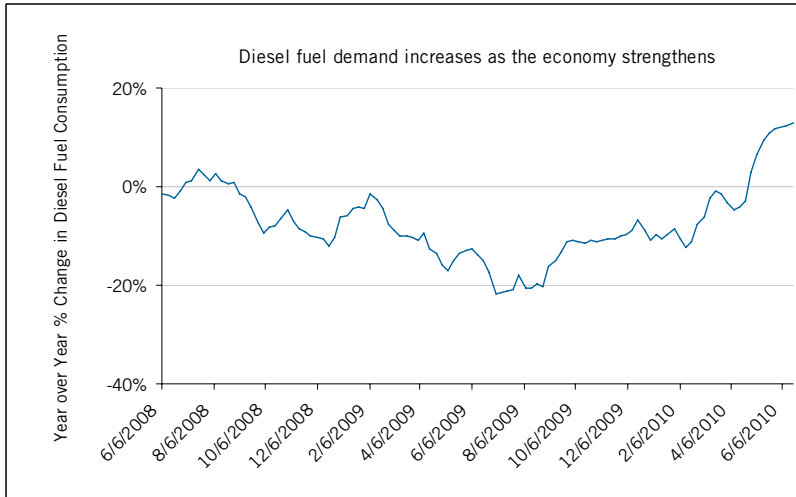
Exhibit 4



Source: Conference Board; Bloomberg

Firm and industry level data has been encouraging, albeit reflecting decisions that may have been made earlier in the year or quarter. For instance, data points such as rail carloads, intermodal traffic, rig count, energy consumption (Exhibit 5),

Exhibit 5

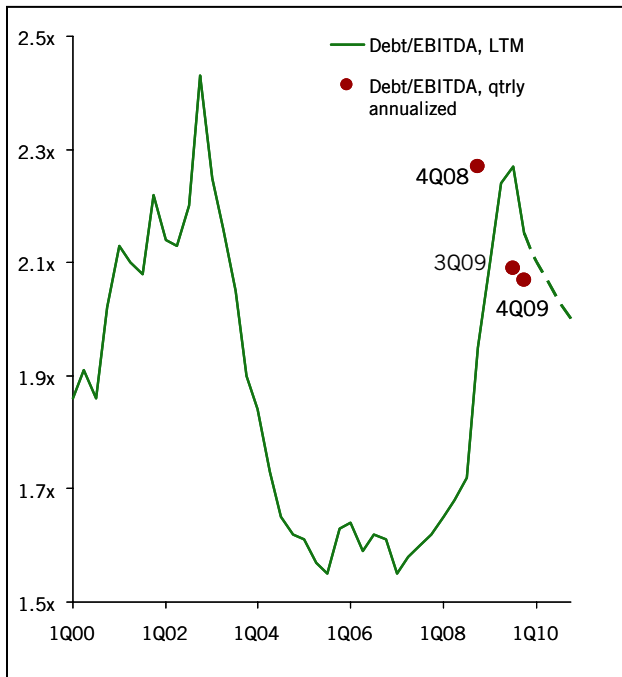


Source: Energy Information Administration

is made available to the public via a statistic or index figure, we will continue to analyze this data and incorporate management commentary and forecasts to make changes to our base case. That said, recent economic data suggests the risk of growth coming in below consensus forecasts has increased.

Our investment mantra earlier this year of “investing in growth” instead of “reaching for yield” reflected our view that investors could benefit from investing in high quality companies in defensive industries. We believed and continue to

Exhibit 6: Fundamentals are improving for investment grade credit



Source: JPMorgan as of 4/2010, total debt of high grade corporate bond issues are represented by the JP Morgan Juli index.

believe that a “slow growth” environment should result in merger and acquisition activity, innovation to differentiate, and industry participant bifurcation where industries are cleansed of weak operators that benefitted from the earlier days of easy money. We are early in this process, but are seeing signs of potential catalysts for the latter (i.e., widening divergence of balance sheets and access to capital for strong vs. weak firms).

At this point, we believe fundamental improvement has taken place in many facets of the economy, including investment grade company balance sheets (Exhibit 6), and a recovery, even

advertising, retail sales on the Industrial side and return on assets, net interest margin and asset quality on the Banking side have all shown improvement from 2009 levels. Acknowledging the time lag that exists from when a decision is made at the consumer and/or business level to when the information

one that is lackluster, is still on track. However, the recent jobs report shows that the labor market has yet to reach the point where it is self sustaining, making our base case forecasts at the credit level vulnerable to downward revisions. The degree of these revisions could affect our opinion on the Corporate credit market, but at this point we continue to expect positive excess returns for those credits that are higher quality and more defensive (e.g., food, beverage, pharmaceutical, aerospace/defense, rails), in addition to high quality banks and believe there are opportunities in the energy sector.

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