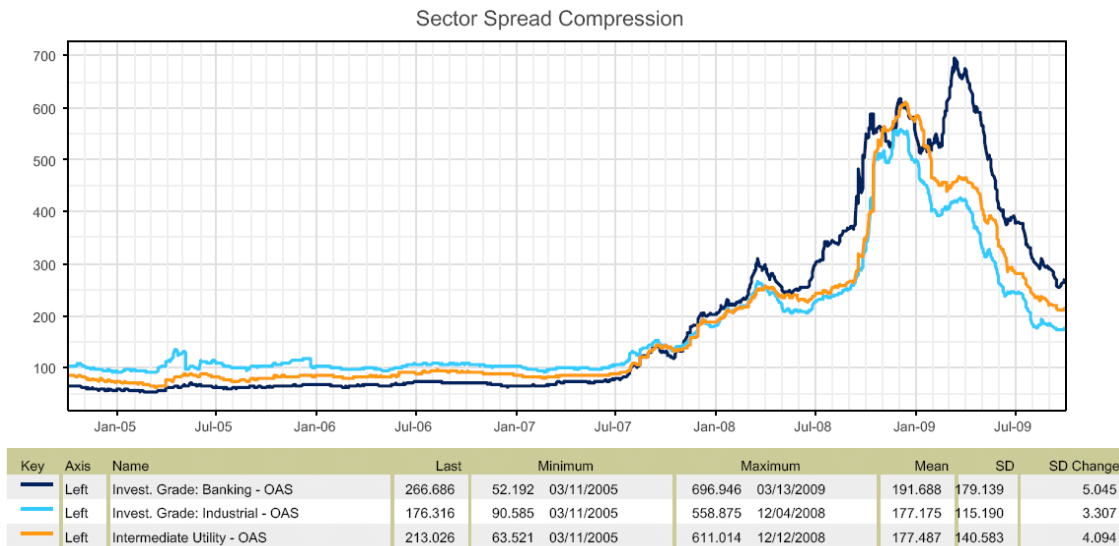


The corporate bond market posted another positive month of excess returns (79 basis points for Barclays Corporate Bond Index). Spread tightening continues in all broad sectors with Finance outperforming, as compression continues between Finance and Utilities/Industrials (Exhibit 1). However, like the equity market, the corporate market has softened recently, as the economic data has been weaker than expected and headlines about unemployment, foreclosures, and budget deficits persist, reminding all of us that a strong recovery is not a “sure thing.” Unlike the consensus of a “V” shaped recovery, we continue to position portfolios for a “U” shaped recovery. We remain concerned with the consumer, housing (both commercial and residential), the government’s role (i.e., exit strategy), and the strength of a recovery on the back of businesses that face more stringent regulation and the prospect for higher taxes, direct and indirect.

Exhibit 1

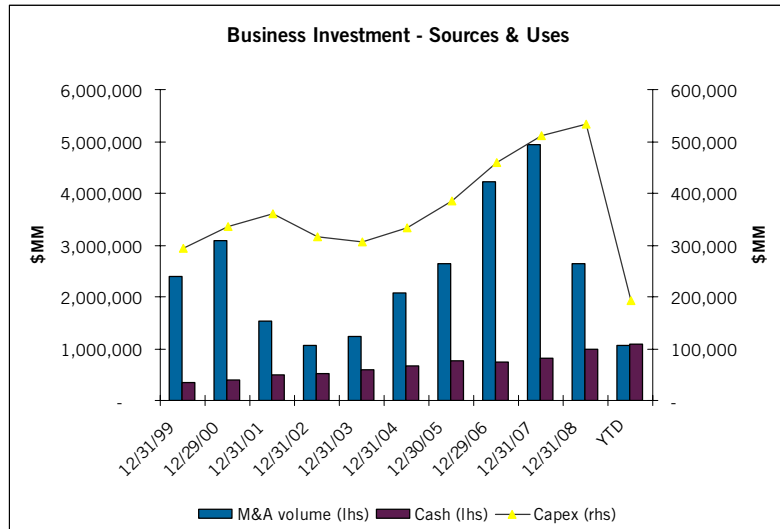


Source: Barclays Capital Market Analytics

Business investment, not consumer spending, has been cited as the source for near term GDP growth not only for the U.S., but for many other countries as well. Economists focus on the inventory drawdown or “output gap” that exists and the positive effects the inventory re-build will have on GDP growth and inflation. We also look to other sources of business investment, mergers and acquisitions (M&A) and capital spending, and note the very low levels at which they are at today and the cash that is available (Exhibit 2). A “U” shaped recovery lends itself to M&A, as companies need to consolidate to accelerate growth. Therefore, we believe this will increase, especially in low/no growth industries such as Finance, Telecommunications, Media, and Consumer Products. Capital spending is more

difficult to forecast given management's reluctance to invest in a weak global economy. We expect industries that are commodities based, like Energy and Metals and Mining, to increase capital spending given the demand from Asia and other higher growth countries.

**Exhibit 2**



Source: Bloomberg

We anticipate less investment being made in special dividends and share repurchases due to the competing investment opportunities that exist, as more companies are looking to sell or shed assets and at the same time, acquisition multiples are lower and financing is still relatively cheap.

This outlook keeps us positive on business led growth, which should help temper the negative drag from the consumer and withdrawal of government spending. However, recognizing the importance of both the consumer and government in this recovery, it also keeps us defensive and highly selective with credits and industries.

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