

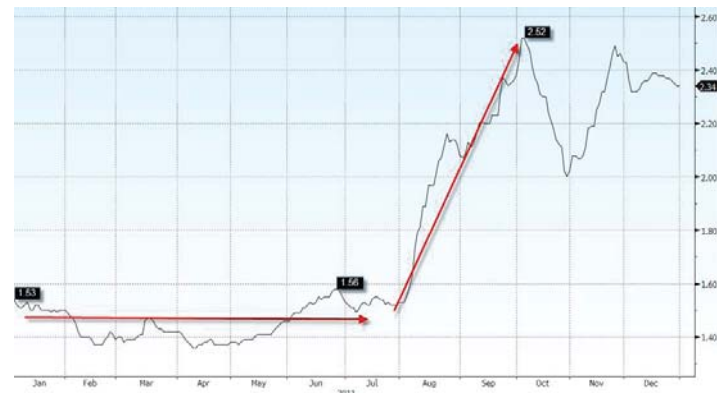
Credit has Repriced...Are Spreads Wide Enough for a Fat-Tailed World?

2011 started off with high hopes for improvement in the global macroeconomic picture and a positive view for risk assets. The world saw some jarring events in the first half of the year, including a devastating earthquake in Japan which disrupted global supply chains and civil unrest in the Arab world which caused a jump in oil prices. In addition to these shocks, worldwide growth was lower than expected. Despite these diverse headwinds, credit markets were stable through the first half of the year, with spreads (as measured by the Barclay's Corporate Index) ending July at 156 basis points, just 3 basis points wider on the year. The relative calm through the first half of the year came to a screeching halt in August as the debt ceiling debate at home and reemergence of sovereign debt fears in Europe took markets from "steady as she goes" to a ferocious sell-off.

First, let's start with the fiasco in the beginning of August. Congressional factions used the debt ceiling debate as a tool to advance their respective agendas, pushing the country to the brink of default. Their political infighting resulted in Standard and Poor's downgrade of America's once sterling AAA credit rating and, more importantly, it sapped confidence from an already fragile market. Secondly, the sovereign debt crisis in Europe, which had faded in the fall of 2010, came back with a vengeance in mid-2011. As default concerns spread from peripheral nations to core European economies during the summer of 2011, complacency turned into outright panic. Italian bond yields soared past 7 percent and the notion that the Euro may disband began to gain traction. The result was a massive flight-to-quality that pushed the yield on Treasuries to generational lows and investors experienced one of the worst spread blowouts in decades. From August to September, the spread on the Barclay's Capital Corporate Index widened 85 basis points, producing a negative excess return of 5.32 percent. The final quarter of the year

witnessed mind-numbing volatility as the markets whipsawed in October and November and everyone sat on the edge of their seat, interpreting the news flow from each "historic" summit of European leaders. The year ended on firmer footing, thanks to strengthening economic data from the United States and progress on fiscal unity in Europe.

Spread Movement for the Barclay's Corporate Credit Index for 2011



Source: Barclays Capital, Bloomberg

As we begin our outlook for 2012, let's start by addressing the situation in Europe and what we believe the likely outcome will be. We believe the market's increasing frustration over European policymakers' gradualist approach will ultimately drive the solution—as soon as markets believe that a solution is unattainable, the problem will get solved by necessity. Take for example the time when Congress turned down the first TARP program only to pass it in the subsequent days as the markets crashed and were frozen with fear. We believe the ultimate solution of European debt crisis will entail a clearer and more thorough backstop from the ECB, but that will not be possible until members of the currency bloc agree to closer fiscal integration—a process that will be painful and a source of great volatility. We see current volatility as a driving force that will lead to an ultimate solution.

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For the year ahead, we expect the U.S. to continue on its “checkmark-like” recovery, with GDP growing at 2 percent and global economic growth in the 3 to 3.5 percent range. The recovery will continue to be choppy and below trend, as the world recovers from decades of debt growth with limited policy options. As highlighted in last year’s CIO letter, “Welcome to the Era of ‘Abnormal Normal’”, our CIO posited that this market cycle will have four distinct phases. Two phases have passed, the market blowout of 2008-2009 followed by the 2009 recovery. We are still in the midst of “The Volatility Phase” that we believe will lead to Phase 4 of a sustainable recovery with declining but above average volatility. We expect this volatility to persist through the majority of 2012 as the markets anxiously await a durable resolution to Europe and the outcome of the U.S. elections in November.

Below we take a more in depth look at the drivers of corporate credit spreads and our outlook for the upcoming year.

Fundamentals: Terrific Shape, Does it Matter?

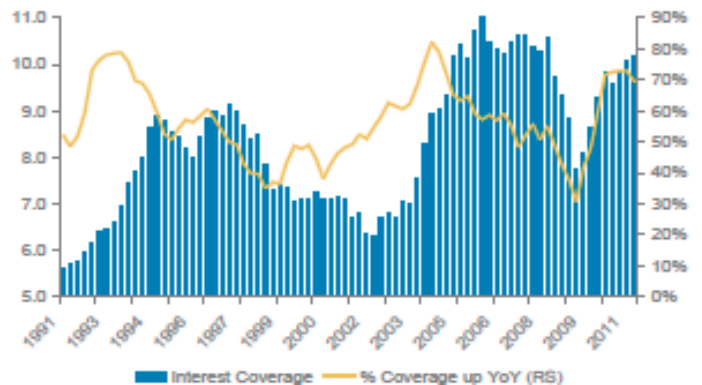
The exceptionally strong fundamental picture of the corporate credit market was overwhelmed by macro concerns and the deteriorating fiscal situation in Europe during the back-half of 2011, and credit markets were re-priced significantly wider. Overall, corporate credit is in fantastic shape, with companies having done an excellent job navigating and recovering from the 2008 financial crisis. Due to lack of clarity surrounding the economy and uncertainty of the sovereign crisis, companies have been very strict on cost controls and conservative in rebuilding their inventories and capital expenditures. This unwillingness to loosen purse strings is most evident in companies’ reluctance to hire additional workers, since management remains concerned over the sustainability of growth and the lack of visibility in tax policy. Revenue and EBIDTA growth vastly outperformed the anemic domestic rebound as a result of productivity gains and stronger than anticipated overseas sales. While many were looking for fundamentals to deteriorate throughout 2011, as

the global economies exhibited slower growth, credit quality ended the year in one of the strongest positions in decades. Rarely has there been such a disconnect between pure fundamentals and valuations, but also rarely has there been such an ominous large “known unknown” in the market.

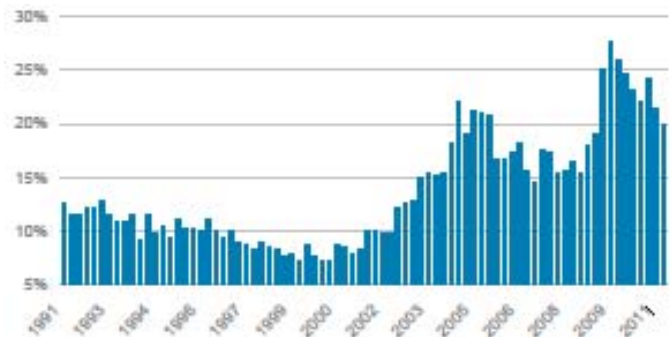
Leverage has Decreased Dramatically¹



Interest Coverage Near All-Time High¹



Cash on Balance Sheets Remains High¹



¹ Source: Morgan Stanley

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So the backward looking metrics look great but we know the market is a forward-looking discounting mechanism. The key question is, where is credit quality headed? Similar to a “AAA” rated security, there is only one way to go when you are at the top. We are at a similar inflection point with credit quality as leverage is low, interest coverage high, and balance sheets are flush with cash. We are of the view that corporate credit is “as good as it gets” within this credit cycle. With that said, we are very comfortable that credit metrics will remain supportive of current valuations given the adequate margin of safety inherent in current spread levels. Our current expectations of domestic GDP growth of 2 percent is supportive for corporate credit for several reasons.

First, moderate, sub trend growth is adequate for moderately levered, investment grade companies to easily meet debt service requirements and provides an environment that is conducive for companies that must refinance maturing debt.

Second, slow GDP growth combined with global uncertainties will keep corporate CFOs from squandering the large cash balances on their balance sheets. Ultimately, we expect the cash balances to be drawn down to reward shareholders in the form of increased dividends and share repurchases, but we do not see this as a major issue for the markets in 2012. Ultimately, we believe that the cash hoards will be deployed to the benefit of shareholders who continue to reel from a decade of no return, but we think this will only be the case when there is greater clarity surrounding the growth environment.

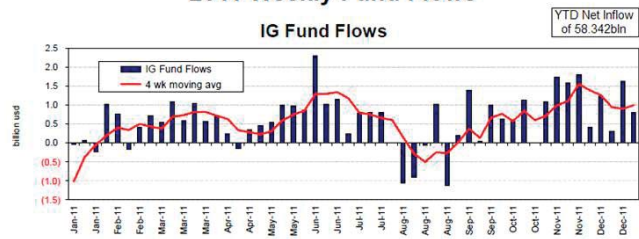
And third, below trend growth in the 2 percent range will be supportive of the asset class and we should not see wholesale shifts out of fixed income into perceived greater return investments, i.e. the equity markets.

Technical: Supportive BUT Liquidity is Horrendous

The technical picture appears to be robust and is similar to trends we saw in 2011 in investment grade credit. On the supply side, we expect issuance to come in around \$750 billion, below last year’s tally of \$850 billion. In 2012 there are approximately \$400 billion of maturities, leaving net issuance of \$350 billion. Financial issuance, both domestic and Yankee, will be the culprit for lower supply as domestic banks continue to deleverage and rely more on deposits and Yankee supply will be muted with European volatility. Demand for investment grade credit will also be aided by the continued low supply in other investment grade products (MBS, ABS, CMBS & CLOs) as the shadow banking has not recovered, so corporates should continue to benefit, filling the void left by the decrease in securitized markets.

Despite all-in yields on corporate bonds being close to all time lows, we believe that the asset class will continue to be supported by the largest holders of corporate bonds: insurance companies and pension accounts who need fixed income to match off against their liabilities. Furthermore, we expect continued support from the mutual fund buyer base as baby boomers continue to ease into retirement and have lasting scars from the two vicious bear markets of the last decade. Our baseline economic view for 2012 would not support a large shift from equities, at the expense of fixed income as the economy continues its below-trend growth.

2011 Weekly Fund Flows



As with many things in life, well-intentioned events often come paired with some unintended negative

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trade-offs. This is the case with the new regulations to be implemented in 2012, as outlined in the Volker Rule within the Dodd-Frank Act. The intent of the rule is to make banks safer and bail-outs less likely by limiting their ability to take large proprietary positions. While the rule has yet to be finalized and is still in the comment period, it will be worth watching how the final rules shake out, as it will have direct implications for the liquidity not only of corporate credit, but other sectors of the fixed income markets as well. This development will not help the situation, however, since liquidity nearly evaporated during the back half of 2011 with sky-rocketing volatility as the “risk on / risk off” mentality gripped the markets. We do not think the volatility is over yet as participants continue to sit on the edge of their seats, watching the seemingly endless news flow from Europe. We ascribe the lack of dealer risk appetite not to anticipated regulations, but rather to the state of paralysis of both buy-side and sell-side firms due to whipsaw price movements.

Dealers are carrying the lowest amount of corporate inventory since 2003, despite the market almost doubling in size in that time frame. The scarce amount of paper available makes credit spreads susceptible to quick snaps, especially if unexpected positive policy announcements cause the market to scramble to buy paper. In other words, the lack of liquidity is a potential accelerant of both wider and *tighter* spreads.

Primary Dealer Positions of Corporate Securities with a Maturity > 1 year

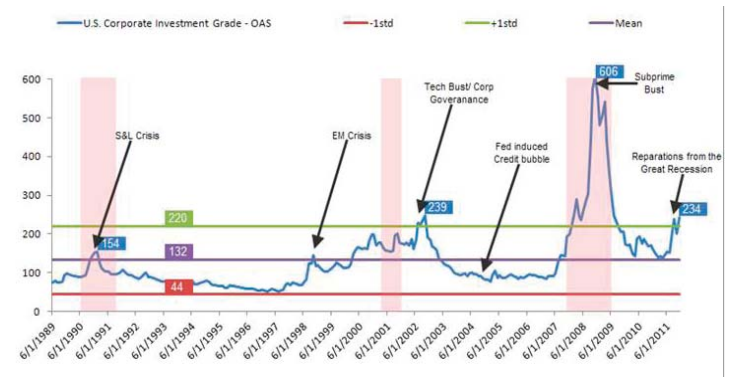


Source: Bloomberg

Valuations: Priced for imperfection, NOT for Catastrophe

Spreads are cheap when compared to historical averages, even after taking the spread blow-out of 2008 into account. Spreads remain elevated as the world continues on its long journey of de-leveraging. Tail risks from policy errors remain, but we believe investors will be rewarded for owning investment grade credit relative to Treasuries, as there is a significant margin of safety. While we acknowledge the current uncertainty, spreads are compensating investors for the associated risks. We do note, however, that should the situation in Europe become unsolvable, (a scenario we do not foresee), spreads may go materially wider. A simple, probabilistic, and market driven model with the assumptions of spreads doubling to 500 basis points in the European meltdown scenario, and our base case of spreads ending the year at 180 basis points, implies a 20 percent probability of a European implosion. We believe this probability is simply too high, given the “pain factor” that would be inflicted on Germany’s export driven economy—if the Euro imploded.

Long Term Spread History for the Barclay’s Capital Corporate Index



Source: Barclays Capital

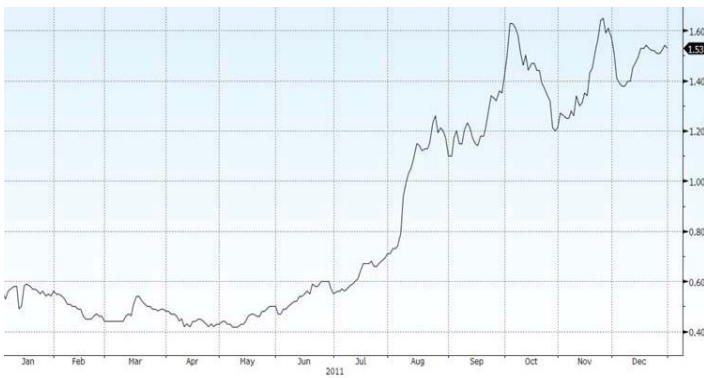
Earlier, we asked “Fundamentals: Terrific Shape-Does it Matter”, the answer is yes. Ultimately, fundamentals will trump fear. Within our macroeconomic outlook and view that Europe will avoid a breakup of the common currency, we are calling for spreads to end the year

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at 180 basis points. If our call plays out, we expect a very strong excess return of close to 4 percent. While we see spreads tightening meaningfully, we do not see spreads getting back to historical norms because there are still challenges ahead for the world economy as we rebuild after the “Great Recession”. Our largest overweight going into 2012 is in the domestic bank and finance sector.

Financial minus Industrials OAS



Source: Bloomberg, Barclays Capital

Our bank overweight is a result of wide valuations, which we believe is a mispricing of the credit risk inherent in these institutions. Bank spreads are overcompensating for risks, as the banks continue to both de-risk and de-lever. Bank capital reserves are above pre-crisis levels and the quality of the capital has improved. Regulation will force the banks to go back and focus more on their traditional businesses and limit their risk taking ability, making them more like utilities. While the new environment may not be favorable to bank equities, these developments are very favorable for the holders of risk above equity in the capital structure.

2012 should be another year of volatility, but patient investors with a bit of a longer-term time horizon should be amply rewarded for owning the asset class.