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Fixed Income Commentary

Volatile Week for High Yield

The high yield market declined 1.97% last week — although returns are still positive for the year at +3.14% — as spreads widened out 68 basis points. The decline was widespread across most asset classes as respective cross-asset correlations rose in tandem, which is typical of a classic risk reduction trade. The S&P 500 declined 48 points and is down 118 points from the highs in April, underperforming the high yield bond market during the last week and for the year (down nearly 2.5%). CCC credits underperformed and led the move wider, falling 3.11% last week. In general, trading was thin and any hint of an equity rally was followed by markets where the offer side quickly became the bid side.

Spreads / Returns

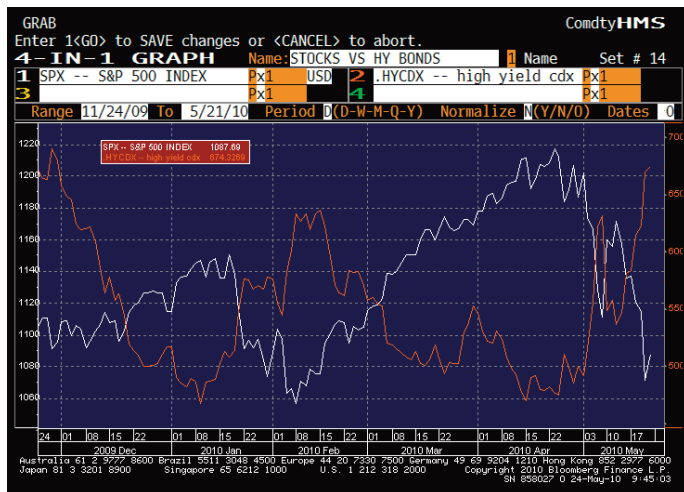
	Spread			WTD	MTD	Total Return		
	4/30	5/14	5/21	Change	Change	1 Week	MTD	YTD
ML 2% HY	561 bp	633 bp	701 bp	68 bp	140 bp	-1.97%	-3.72%	3.14%
BB	411 bp	470 bp	520 bp	50 bp	109 bp	-1.38%	-2.79%	3.58%
B	558 bp	629 bp	693 bp	64 bp	135 bp	-1.71%	-3.34%	1.95%
CCC	864 bp	962 bp	1071 bp	109 bp	207 bp	-3.11%	-5.43%	5.43%
5 Yr UST	2.42%	2.16%	2.02%	-14 bp	-40 bp			

Source: Bank of America Merrill Lynch

Meanwhile the VIX rose to levels not seen since March 2009, when the S&P 500 was at recent lows (see attached charts). This action suggests that investors were not only fearful of price declines, but also uncertain about the direction of asset classes in the short term (the VIX measures risk neutral variance of the S&P 500 over the next 30 calendar days). Arguably, investors have gone from risk-seeking/indiscriminate in late April (VIX at 15) to risk-reduction/fearful (VIX at 48) in just one month. In fact, since 1986, the VXO (VIX predecessor) has exceeded 40 only seven times ('87, '89, '97, '98, '01, '08, '10). While several explanations were used to explain the week's activity, such as European contagion, a slowdown in China (the Shanghai Composite is down 18% this year and 25% from the highs last August) and financial reform, perhaps what is more telling is the lack of buyers on weakness, a flatter yield curve and a decline in commodity prices. While most metrics in the rearview mirror suggest a nascent cyclical recovery, the future is increasingly uncertain given secular headwinds. Inflation appears to be the least of investor worries at the moment.

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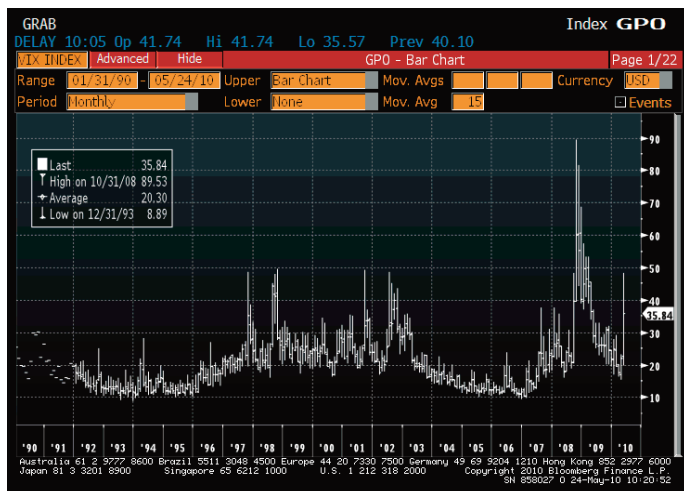
Volatile Week for High Yield (cont'd)



Given the recent deflationary trends/trading environment, it's worth noting that Leveraged Loan mutual funds flows were positive last week and now exceed high yield bond mutual fund flows for 2010 (\$4.5 billion versus \$2.3 billion). Perhaps investors like the credit convexity of loans right now given their seniority in the capital structure and floating rate coupon. While loans may underperform in a sideways market, they should outperform in a down market (senior to unsecured bonds) and an up market (higher Treasury rates/LIBOR). We agree with that sentiment and continue to like floaters and leveraged loans.

Fund Flows / New Issues

- Seven bond deals priced, totaling \$2.2 billion (2nd lowest week this year)
- High Yield bond mutual fund flows were -\$378 million, following last week's near record -\$1.7 billion outflow (+\$2.3 billion YTD)
- Leveraged loan mutual fund flows were +112 million (+\$4.5 billion YTD)
- The forward loan calendar is currently north of \$19 billion (~ 50% refinancing)
- Default volume is only \$800 million YTD, versus \$94.6 billion in 2009



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