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METWEST

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Fixed Income Commentary
High Yield Spreads Tighten

Risk taking is back for the moment, despite mixed economic news in the week ended June 18. The high yield market returned 1.8%, almost entirely via tighter spreads, which dipped below +700 basis points (bps) on Friday and continue to tighten this week. CCC bonds outperformed by a healthy margin, leaving the CCC/B spread premium at a skinny +371 bps. While the industrial production number was strong, the Philly Fed and retail sales data were well below expectations and the Economic Cycle Research Institute weekly leading indicator of -5.7% suggests anemic to flat growth later this year. The non-farm payrolls estimate for June is currently -65,000 due to a reduction in Census workers, which will certainly give the bears some fodder over the next two weeks.

Most of the trading volume in corporates was centered around the oil spill credits (BP and related names), which staged a solid rally off the lows on Tuesday, June 15. BP formally announced it will establish a $20 billion escrow fund for economic and punitive damages. Anadarko Petroleum (APC) was formally downgraded to high yield by Moody's late Friday, although arguably the bonds are currently trading like a single-B energy credit already in the mid-8% range. The bonds for all three credits – BP, APC, Transocean (RIG) – are currently in the processes of moving from traditional investment grade accounts to high yield investors. BP is rumored to be doing a secured loan deal, which may help them set pricing for an unsecured deal later to fund the escrow account. We expect the volatility to continue here.

Oil spill bonds weekly change

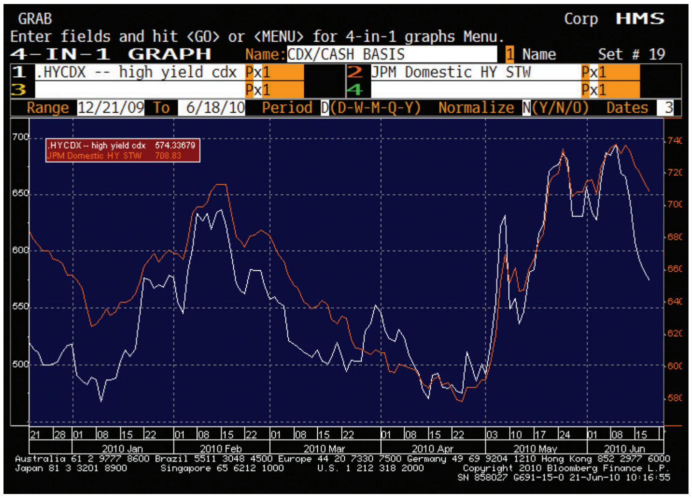
APC 19s	+6 pts
RIG 18s	+7 pts
BPLN 19s	-5 pts

Spreads/Returns

	Spread			WTD	MTD	Total Return		
	5/31	6/11	6/18	Change	Change	1 Week	MTD	YTD
ML 2% HY	698 bp	728 bp	683 bp	-45 bp	-15 bp	1.80%	1.19%	4.60%
BB	521 bp	545 bp	512 bp	-33 bp	-9 bp	1.40%	0.98%	4.61%
B	697 bp	724 bp	681 bp	-43 bp	-16 bp	1.58%	1.08%	3.29%
CCC	1061 bp	1122 bp	1052 bp	-70 bp	-9 bp	2.54%	1.33%	7.02%
BB/B	176 bp	179 bp	169 bp	-10 bp	-7 bp			
CCC/B	364 bp	398 bp	371 bp	-27 bp	7 bp			
5 Yr UST	2.09%	2.03%	2.01%	-2 bp				

Source: Bloomberg

High Yield Spreads Tighten (cont'd)



Source: Bloomberg

Away from the oil spill credits, volume was centered around credit default swaps (CDS) which significantly outperformed cash bonds (see first chart). Fund flows were positive for the first time in nearly two months, which combined with very little new issuance led to heavy buying of CDX risk. In fact there were several new issues that we brought back to life today and I suspect we'll see more this week.

The one sector that has not participated in the rally is strangely homebuilders. CDS is only marginally tighter and stocks in the S&P 500 Homebuilders Index (Lennar, D.R. Horton, Pulte Homes, second and third chart) closed near their lows Monday. Could this be a sign of weaker housing in the second half of 2010?

Fund Flows/New Issues

- One high yield bond deal priced totaling $250 million
- Two loan deals priced totaling $950 million
- High-yield mutual fund flows were +$271 million, the first inflow in seven weeks
- Bank loan fund inflows were +$77 million

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