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GLOBAL MARKETS OUTLOOK

MFS INVESTMENT MANAGEMENT®

Equity Outlook

by Jeffrey D. Morrison, CFA

IN THIS ISSUE

EXECUTIVE SUMMARY

In the third quarter, decelerating global growth combined with worries about political dysfunction in both Washington, D.C., and the eurozone to send stocks plunging and volatility soaring. Jeffrey Morrison, in his Equity Outlook, notes that in the equity market, valuations remain attractive but that the earnings outlook continues to deteriorate. He adds that going forward stock market direction and leadership will be controlled by macro forces and technical factors. In his Fixed-Income Outlook, Robert Hall warns that the tail risk of the debt crisis in the peripheral countries of the eurozone and the United States appears the most significant threat to continued global expansion. Against this backdrop, Rob adds, the prospect of making an accurate near-term directional call on interest rates remains daunting.

Global economy at a crossroads; political roadblocks on the horizon

"Nearly all economists love to say, 'The stock market has called nine of the last five recessions.' That is a very cute phrase and does have some truth to it. The only problem is that as a group, economists have called none of the last seven recessions..."

Ned Davis – *Institutional Hotline* – September 2, 2011

Q3 Review – Political dysfunction and global economic uncertainty

The summer vacation quarter was anything but relaxing for global equity investors. Increasing concerns that the deceleration in global growth would develop into a recession, combined with political dysfunction in both Washington and the eurozone, caused volatility to spike and equities to plunge. The MSCI All Country World Index (ACWI) ended the quarter with a 17.3% decline.

The eurozone sovereign debt crisis dominated the headlines throughout the summer, causing wild swings in equity markets and investor confidence. A proposed agreement by the EU leaders to bolster and enhance the European Financial Stability Facility (EFSF) bailout fund followed by a European Central Bank (ECB) decision to buy Spanish and Italian bonds did little to quell the concerns of investors, who are growing increasingly weary of the "kick the can down the road" approach. Nor were investors soothed by commitments by G7 central banks to coordinate policy in the event of a seizing up of global banking liquidity.

Late in the quarter capital markets came unglued as fears of an imminent Greek default and the impact of contagion to the global financial system drove a rush to safety. Equities, emerging market currencies, and precious metals — the latter two previously perceived as safe havens — sold off significantly. In the final week of the quarter, equities lurched higher, recovering some of the losses, amid rumors that global leaders had worked out a plan that would stem the sovereign debt crisis.

(continued on next page)

EQUITY OUTLOOK

JEFFREY D. MORRISON, CFA

INSTITUTIONAL PORTFOLIO MANAGER

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He joined MFS in 2006 and has 22 years of experience in the industry as an equity portfolio manager, capital markets analyst, and trader.

Jeff earned a Bachelor of Business Management (BBM) degree from Ryerson Polytechnical Institute. He holds the Chartered Financial Analyst designation.

Not to be outdone by their counterparts across the Atlantic, policymakers in Washington created some market-moving headlines of their own during the quarter. A showdown between the Obama administration and congressional Republicans over an increase in the debt ceiling clearly illustrated the growing dysfunction in Washington. The resulting agreement fell short of Standard & Poor's Ratings Services' expectations and prompted a controversial downgrade of the US government's AAA credit rating. The change was not confirmed by other prominent rating agencies. A high-profile letter by Republican leaders caused further controversy. The letter questioned the efficacy of the first two rounds of monetary easing and warned US Federal Reserve Board Chairman Ben Bernanke against pursuing another round of quantitative easing. The subsequent announcement of "Operation Twist" met with disappointment from investors who were looking for a much larger amount than that announced. In its announcement of the so-called operation, the Fed said it would sell $400 billion in short-term bonds and buy the equivalent in long-term bonds. The exchange is designed to further reduce yields.

Political drama in both the United States and Europe had a significant impact on business and consumer confidence and put further downward pressure on a global economy reeling from a number of transitory issues (Japan earthquake/tsunami, extreme weather in the US Midwest, and high oil prices related to tensions in the Middle East) from earlier in the year. Around the globe, purchasing managers' indices (PMIs) significantly decelerated during the quarter, with many countries and regions dipping below 50, signaling contraction. The PMIs are surveys of businesses designed to provide a gauge of what is happening in the economy by tracking changes in production, new orders, inventories, employment, and prices. Global consumer confidence surveys echoed the weakness in business surveys, with many dropping to levels consistent with a recession. While recent data reports don't confirm the recession, the evidence from the survey clearly indicates that the global economic expansion is at a crossroads.

The decline in the MSCI ACWI during the third quarter was led by eurozone equity markets, which were negatively affected by sovereign debt contagion fears and a quickly deteriorating economic outlook. Emerging markets, particularly in Asia, lagged the broader benchmark as well, driven by increasingly restrictive monetary policies and decelerating growth expectations at home and abroad. Other notable underperformers included the Nordic markets of Sweden, Denmark, and Finland.

Relative geographic outperformers during the quarter included UK equities, which led all developed markets, as investors widely anticipated another round of quantitative easing in response to weakening economic data. Japanese equities also put in a strong showing, driven by expansionary fiscal policies and purchases of equity exchange-traded funds by the Bank of Japan (BOJ) coupled with cheap valuations and an improving earnings outlook. US and Canadian equity markets were other noteworthy outperformers during the quarter, as were the emerging markets of India, Turkey, and South Africa.

(continued on next page)

EQUITY OUTLOOK

With the pace of the global expansion clearly in deceleration mode, sector leadership was broadly defensive, with the health care, consumer staples, telecom, and utilities sectors significantly outperforming the MSCI ACWI. In what may be a surprise to some, the information technology sector also outperformed. That outperformance reflected the sector's attractive valuations and its increasingly defensive qualities of less cyclical-end demand and healthy balance sheets. Not surprisingly, financials were the worst-performing sector during the quarter as the threat of defaults and contagion in the eurozone weighed heavily on the global banking sector. The industrials, materials, and energy sectors also struggled during the quarter in response to a deteriorating global economic outlook.

Economic outlook

The outlook for the global economy continues to worsen, with central banks, sell-side firms, and the International Monetary Fund (IMF) all cutting their economic growth forecasts in recent weeks. Global business surveys and capital market indicators, like equity market leadership, commodity prices, and yield spreads, suggest the weakness will persist or intensify. Additionally, political issues are likely to overhang business, consumer, and investor confidence for the foreseeable future. On the brighter side, monetary policy generally remains stimulative in the developed economies and will likely become less restrictive in emerging economies as inflation pressures ease. Lower fuel and food prices, which act like a tax cut for consumers, should be supportive of consumption.

On the political front, expectations are so low that any signs of meaningful progress by eurozone policymakers in dealing with the debt crisis or an agreement from the US Congressional Joint Select Committee on Deficit Reduction would remove significant macro risks. Having said all that, we expect the global expansion to continue, albeit at a sluggish pace. The risks are clearly to the downside.

US – Sluggish growth expected to continue, but the risk of a recession has increased

As discussed in last month's report, the political dysfunction in both the United States and Europe had a significant impact on business confidence and resulted in a number of regional manufacturing surveys declining to levels consistent with a recession.

While a number of forward-looking indicators point to further economic weakness, particularly in the manufacturing sector, recent reports on industrial production and nondefense capital goods ex-aircraft orders (a proxy for capex) suggest sluggish growth but no recession.

Additionally, while the Business Roundtable's CEO Economic Outlook Index for Q3 has fallen to its lowest level since the end of 2009, expectations for sales, capital expenditures, and employment over the next six months, while moderating, remained in expansion territory.

Consumer confidence, which was already depressed, was hit hard by the midsummer political shenanigans. A persistently depressed housing market, combined with renewed weakness in employment and an unexpected decline in

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personal income also took its toll, resulting in disappointing August retail sales. While reduced fuel prices will provide some relief to consumers, the employment recovery appears to have stalled.

Fiscal and monetary policies are pulling in opposite directions. The Fed remains stimulative, implementing Operation Twist and signaling that short-term rates will remain at zero through mid-2013. The fiscal outlook is much more challenging as policymakers continue to battle over a variety of issues, including the president's recently announced jobs bill and the 2012 budget and trade agreements with Korea, Panama, and Colombia. Additionally, Congress' Joint Select Committee on Deficit Reduction must come up with $1.2 trillion in budget savings; failure to come to an agreement would force economically damaging across-the-board cuts equally divided between defense and nondefense programs.

While our base case is that the US economy continues to expand at a sluggish pace, the risks of a recession have increased. The spread of the eurozone sovereign debt crisis, political challenges in the United States, and slowing global growth all have the potential to negatively affect our outlook.

Europe – Eurozone on the verge of recession

The most significant issue affecting Europe remains the ongoing eurozone sovereign debt crisis. The German parliament's late September passage of the proposal to expand the size and powers of the EFSF makes it increasingly likely that member countries, who have yet to vote, will also approve the changes by mid-to-late October. While the ECB, through its sovereign bond purchases and coordinated effort with other central banks to offer unlimited dollar funding to European banks, has temporarily contained the crisis, bolder policies are required by European leaders to end the crisis. Having said that, the piecemeal policy approach to the crisis is likely to continue, as recently rumored proposals aimed at an increase in the EFSF's lending capabilities from €440 billion to €2 trillion face many political hurdles and put at risk the credit rating of more eurozone nations.

On the economic front, austerity measures, ECB interest rate policy, and slowing global growth are all weighing heavily on the outlook for the region, making it difficult, and in the case of Greece impossible, to meet fiscal goals. While countries at the epicenter of the crisis are either on the verge of or already in recession, a number of indicators suggest the economies of core eurozone countries are also decelerating quickly toward a possible recession. For example, while indicators for Germany remain consistent with expansion, the recent drop in the IFO Index, historically a good predictor of future GDP growth, suggests the economy is close to dropping into recession. Additionally, the eurozone economic sentiment indicator has dropped to its lowest reading since December 2009, with broad-based weakness across all the core member nations. The crisis-related decline in the euro and expectations for a reversal of ECB rate hikes later in the year will provide some relief in light of the numerous challenges facing the region.

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EQUITY OUTLOOK

Japan – Recovery from the earthquake and tsunami moderating

The Japanese economic recovery from the earthquake and tsunami earlier in the year is moderating as a strong yen and weaker overseas economies partially offset a more constructive outlook for domestic demand driven by fiscal spending on reconstruction.

Business surveys confirm the counteracting forces affecting the outlook for the Japanese economy. The Japan Markit PMI dropped below 50 into the contraction zone whereas the Cabinet Office's Leading Economic Index and the Shoko Chukin business confidence index both remain in expansion territory. Further, a recent business outlook survey indicates that companies intend to increase capital expenditures by 5.4% in fiscal 2011, an increase from 4.9% in the May survey. With expectations for ¥19 trillion of reconstruction stimulus over the next five years, capital investment will likely remain cyclically robust.

While consumer confidence remains depressed, consumer spending has been surprisingly strong, driven by robust reconstruction demand and quickly recovering employment trends. Even though the stimulus mentioned above is slated to be funded by tax increases over the next 10 years, the impact on the consumer should be mitigated in the near term as the increases are expected to be small in the early years.

Emerging economies – Inflation likely peaking; concerns over hard landing increasing

With expectations of an imminent peak in inflation and a deteriorating outlook, the trend toward tighter monetary policies was punctuated by a surprise cut of the Selic rate by Brazil's central bank in mid-August. While inflation in a number of emerging economies does appear to be peaking, it is probably too soon to say the battle against inflation has been won, given stubbornly high food prices, firm labor cost trends, and more recently, weaker currencies. With inflation still at elevated levels, it is unlikely that policymakers outside of Brazil will start easing policies anytime soon.

The accumulated impact of tighter monetary policies and a worsening growth outlook globally is clearly beginning to weigh on growth expectations for emerging economies. In fact, some now fear a hard landing. Business surveys and leading indicators, which have been warning of the potential for slowing growth, continue to deteriorate, and we are beginning to observe increasing weakness in real economy data like industrial production and retail sales data. While a hard landing is always a possibility, sound underlying fiscal fundamentals in most emerging economies provide policymakers with the monetary and fiscal flexibility to respond to weakening economic conditions.

Equity outlook and strategy

Seasonally, the fourth quarter has historically been strong for equities; however, the unresolved crisis in the eurozone, combined with political hurdles in the United States and uncertainties around the outlook for the global economy, suggests the direction and leadership of equity markets will continue to be largely driven by

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macro forces and technical factors. While valuations are generally attractive, the earnings outlook continues to deteriorate globally. Our outlook on a geographic basis is to continue favoring developed over emerging markets, with an emphasis on the United States and Japan. While from a secular perspective, emerging markets continue to look attractive, from a cyclical point of view, slowing economic and earnings momentum, combined with unattractive relative valuations and weakening technicals, keeps us cautious.

The business cycle has advanced to the latter stages, suggesting the recent shift in market leadership to defensive, early-contraction sectors (health care, consumer staples, and select parts of technology, utilities, and telecommunications) is likely to persist. On a style, quality, and size basis, the economic and earnings outlook clearly supports growth (earnings and dividends) and high-quality and large-cap stock leadership. With markets technically oversold, any positive developments in the eurozone crisis could result in a powerful rally in cyclical stocks, particularly in the financial sector.

Finally a review of a number of technical gauges suggests equity markets remain on shaky ground. Many have pointed to the numerous successful tests of the August 8 lows by the S&P 500 as evidence that the decline is over. However, technicals continue to worsen, with the NYSE advance/decline line breaking to new lows and close to 700 stocks having since made new 52-week lows, most in the cyclical sectors. On a global basis, many indices have broken below the early August lows, including the MSCI ACWI (local). Additionally, a new indicator from Arthur Budaghyan at BCA Research indicates that the selloff in global equities has coincided with the global-cumulative advance decline line's breaking below its 80-week moving average; historically, this has signaled that global equities are entering a bear market, with further declines anticipated.

Summary

In summary, we expect the uneven, sluggish global expansion to continue; however, there is a risk that one or more of the major developed countries or regions will fall into recession. Emerging economies are poised for a soft landing as less restrictive monetary policies — in response to peaking inflation and slower global growth — remove a significant headwind. Having said that, the quotation above from Ned Davis should act as a reminder of the importance of staying in sync with the markets as equities have historically had a better record of signaling recessions than economists or Wall Street strategists.

As for equities, macro uncertainties, in combination with a challenging earnings outlook and weak technicals, keep us squarely in the defensive camp. Developed markets should continue to outperform emerging markets; however, less restrictive monetary policy and evidence of a soft economic landing may perhaps alter this view in the coming months. Defensive sectors remain well positioned to continue their leadership until we get better clarity on the endgame in the eurozone and/or signs the global economic outlook is stabilizing.

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EQUITY OUTLOOK

MSCI indices (gross)

Name	1 month	3 months	YTD	1 year
Japan	-0.80%	-10.64%	-15.18%	-7.67%
EM Latin America	-5.27%	-11.56%	-17.48%	-13.92%
Pacific	-3.68%	-11.90%	-14.99%	-9.11%
EMEA	-6.85%	-12.29%	-12.41%	-4.75%
Europe ex-EMU	-3.69%	-13.17%	-12.12%	-6.87%
Pacific ex-Japan	-8.26%	-13.89%	-14.68%	-11.30%
USA	-7.19%	-14.03%	-8.72%	1.34%
ACWI	-6.19%	-14.72%	-12.55%	-5.52%
EM	-7.40%	-14.92%	-16.53%	-11.72%
EAFE	-4.32%	-15.68%	-15.23%	-10.44%
EM Asia	-8.35%	-16.90%	-17.21%	-12.69%
BRIC	-10.11%	-18.97%	-21.58%	-19.23%
EMU	-5.75%	-22.56%	-18.79%	-15.57%

Source: Bloomberg. Returns in local currency, as of 9/30/11.

MSCI AC world sectors (price)

Name	1 month	3 months	YTD	1 year
Consumer staples	-2.04%	-4.61%	-1.52%	2.30%
Telecom	-1.98%	-7.37%	-6.14%	-4.01%
Utilities	-0.62%	-7.46%	-9.22%	-8.27%
Health care	-2.31%	-8.76%	-0.87%	1.59%
Information technology	-3.05%	-9.99%	-11.27%	-2.36%
ACWI	-6.45%	-15.31%	-14.49%	-8.01%
Consumer discretionary	-6.32%	-15.71%	-12.30%	-3.87%
Energy	-10.01%	-18.88%	-15.64%	-3.25%
Financials	-8.60%	-20.93%	-23.25%	-20.15%
Industrials	-8.66%	-21.30%	-19.75%	-11.77%
Materials	-13.25%	-21.87%	-24.36%	-13.54%

Source: Bloomberg. Returns in local currency, as of 9/30/11.

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MFS INVESTMENT MANAGEMENT

Fixed-Income Outlook

by Robert M. Hall

ROBERT M. HALL

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Rob joined MFS in 1994 as a marketing associate for MFS Institutional Advisors, Inc., and later became responsible for client service for the firm's non-US separate account clients. He formerly served as a vice president of marketing at MFS International Ltd., a subsidiary of MFS. During his tenure he served as the division's senior product manager, providing information about portfolio positioning and strategy and serving as a liaison with portfolio management.

Rob graduated from Gordon College with a bachelor's degree. He earned a master's degree in education from the University of Massachusetts, Lowell.

Duration/Rates

US and global macroeconomic data have continued to weaken, though in our judgment they are not yet consistent with the widespread expectation of imminent recession. As such, our base-case expectation remains one of continued modest global growth. GDP growth in the developed markets could fall to below-trend levels, while growth in the emerging markets may cool to levels close to or modestly above potential. In the United States, we are closely watching for evidence that the weak sentiment underlying recent poor survey data is feeding back into growth and causing a deterioration in the "hard" data. As yet, there is little conclusive evidence of this, despite the softness of recent readings. Final private domestic demand, while not robust, still appears relatively resilient.

In our view, the tail risk of the debt crisis in the peripheral countries of the eurozone remains the most significant threat to continued global expansion. The most widely recognized means of potential transmission to global growth continues to be the risk of a "shock" emanating from the European banking/financial system, but another possible scenario is that austerity measures push the eurozone into a recession, which in turn leads other global regions into a downturn. We remain of the view that a recapitalization of the European banking system would likely bolster market confidence, allowing policymakers more time to implement other needed measures, including steps toward the formalization of fiscal union, expansion of the EFSF, and restructuring of Greek debt. While a comprehensive TARP-like bailout of the more fragile eurozone banks seems unlikely to occur anytime soon, we think there is some scope for individual countries to take action. From our perspective, steps to shore up market confidence are critical, as the chief risk is that the market may move faster than eurozone policymakers can act to achieve a resolution of the major issues. In other words, market repricing of assets could, by producing substantial losses, transform a negative (and not necessarily fully accurate) perception into reality. Given policymakers' apparent reluctance to pursue proactive and pre-emptive action, more market stress may indeed be a prerequisite for decisive policy action. The one thing that does seem highly probable at present is that a resolution of the crisis is still distant and that uncertainty and market volatility will consequently persist for some time to come.

While momentarily out of the limelight, the deteriorating U.S. debt dynamic remains another significant tail risk to global growth. In our view, the pathway to an improved fiscal situation in the United States is somewhat clearer than the pathway to solving Europe's woes. That pathway would be bipartisan compromise and reconciliation between Republicans and Democrats. While this accord is still elusive, it seems easier to achieve than reaching an agreement among all the parties influencing the eurozone policy deliberations. For the moment, the market seems willing to allow the United States more time to resolve its problems than Europe.

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FIXED-INCOME OUTLOOK

Last month, the US Federal Reserve Board announced the implementation of "Operation Twist" (the selling of shorter maturity Treasuries held on its balance sheet in order to purchase longer maturities) with the intention of flattening the yield curve to reduce borrowing costs and thereby stimulate the economy. Although we note that the size and scope of the program generally exceeded market expectations, it is not clear to us that this action will exert a material positive impact on the health of the economy. While it seems reasonable to expect that the Fed buying further out the curve (while holding the federal funds rate steady) will induce flattening, other developments — such as any significant improvement in global macro data or the eurozone debt crisis — could have as much, if not more, of an impact on the level and shape of the US yield curve.

Against this backdrop, we think that the prospect of making an accurate near-term directional call on US rates remains daunting. As a consequence, our bias has been to stay close to neutral duration in those portfolios that have some latitude to deviate from benchmark indices.

In our view, US Treasuries continue to offer poor value for the longer term. We think that easy monetary policy and a flight to quality have kept yields lower than the underlying fundamentals warrant, and we therefore expect that rates may rise modestly over time. At the same time, we recognize that the prospect of an extended period of slow growth and subdued inflation will likely check the pace of any increase in rates. Therefore Treasury yields should remain in a range.

TIPS

We are maintaining a negative bias on TIPS versus nominal Treasuries. In our view, breakevens could go lower if there is further evidence of economic weakness. Nearly all of the yield on nominal 10-year notes is currently inflation compensation, leaving room for the real yield component to rise. With these dynamics in place, we think TIPS could underperform nominal Treasuries.

Agencies

Agency spreads have remained tight to Treasuries, and in our view, the asset class consequently remains unattractive versus other spread product.

Mortgage-backed securities

While our overall view on the relative value of mortgage-backed securities has remained broadly neutral, we think the sector has gradually become more attractive. We believe that MBS offer good carry versus Treasuries, and given the roll-down potential of Treasuries (*i.e.*, the potential for return driven by yields falling as maturities shorten) is a less significant sacrifice given the recent flattening of the Treasury curve. We think the MBS sector could offer lower volatility than many other spread markets amid fears of recession and negative outcomes for tail risks, but we nevertheless remain wary of the technicals in the sector. Specifically, any discussion of government action to modify or refinance mortgages could be a source of volatility in the MBS market.

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Investment-grade corporates

It has become the fashion in the media to draw parallels between the financial crisis of 2008 and that of 2011. In our view, some of these comparisons are apt (such as the locus of risk being yet again in the developed markets, not in the emerging markets), while others are less appropriate. One area where we see significant differentiation between conditions prevalent in 2008 and those characterizing the current environment is the underlying fundamentals of corporate bond issuers. In our view, corporate fundamentals — for both high-grade and high-yield issuers — are better able to weather a storm today than they were in 2008. We note, for example, that balance sheets are generally in much better shape than they were several years ago.

We feel that high-grade corporates have priced in a moderate recession and are thus attractively valued for our base case of continued slow growth. While we feel the recent selloff has created opportunity, we are attempting to respect the tail risks by remaining cautious about adding risk to portfolios. With the tail risks still unresolved, we think it may be premature to add risk in a number of the more exposed financials, for example. On the other hand, we see good opportunities in certain less economically sensitive industries, such as tobacco, natural gas pipelines, wireless tower companies, and consumer staples. We believe that many companies in these and other more defensive market segments can continue to comfortably service their debt even if our base case of modest economic growth proves incorrect.

We are trying to use our credit research capabilities to uncover compelling value produced by market inefficiencies. One area where we continue to find good value is in the "5B" or crossover area. Here we believe we can find companies with high-grade credit metrics that are still offering the higher-yield characteristic of below-investment-grade companies as well as the potential for capital appreciation should an upgrade occur. In our view, this market segment could offer credit investors one potential solution to the problem of historically low bond yields. The conundrum for credit investors in search of higher yield is whether to move further out the yield curve or down the quality spectrum. Increasingly lower yields have extended the duration in the corporate bond market, resulting in less yield compensation per unit of duration risk accepted. For investors concerned about interest rate risk, we believe that moving modestly down in quality may be a more desirable risk/reward option than moving out the curve.

High-yield corporates

In our view, valuation in the high-yield corporate bond sector has improved with recent spread-widening, and many bonds have become attractively priced for a macro scenario in which weak economic growth continues. High-yield fundamentals remain reasonably strong, with less leverage, lower interest expense, and a longer-term structure of debt (*i.e.*, less refinancing risk) than was prevalent several years ago. As a result, we think defaults are likely to remain low by historical standards.

Our dedicated high-yield portfolios benefited from more cautious positioning entering the third quarter. Now that relative valuation has become more attractive (average yields greater than 9.5%, bond prices roughly 10 points lower since May), we have taken advantage of the recent dislocation to selectively add to the portfolios'

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overall risk budgets. Specifically, we have found opportunities in technology, health care, and selected international corporates. Conversely, we have trimmed exposure to financials, having been mindful of elevated systemic risks posed by the European sovereign crisis. Looking across the credit spectrum, we see the most attractive risk/reward potential in the upper and middle tiers of the high-yield market. In our view, the lower-rated segments are still most vulnerable to prolonged periods of weak growth and limited access to capital.

While we have begun to turn more bullish on the asset class overall, we are attempting to be vigilant regarding the sector's volatility and its historical ties to US equity market performance. Indeed, we believe investors should view a high-yield allocation as the most defensive element of an equity portfolio, rather than take the more traditional view of considering it the most aggressive component of a bond portfolio. This is because high-yield bonds have historically tended to exhibit a high degree of participation in the upside of the equity market, while generally protecting better on the downside.

Emerging market debt

While global growth expectations have been downgraded in response to fears of recession and negative outcomes to tail risks, we think that a significant differential should remain between developed market and emerging market growth. In our view, domestic demand remains strong enough in many emerging market countries to allow them to withstand a mild developed market recession without following suit.

Both fundamentals and technicals for emerging market debt remain sound, but with the global macro backdrop as uncertain as it has been, our bias in portfolio construction has been to stay relatively cautious in the near term. This caution is aimed more at selective reduction of risk exposures where the risk/reward has turned less favorable (*e.g.*, in less liquid and/or more economically sensitive names), as opposed to wholesale de-risking. Where attractive opportunities have arisen, we have added exposure. With supportive emerging market fundamentals, US Treasury yields that seem unlikely to rise to any significant extent in the near term, the Fed's implementation of Operation Twist, and the expectation of continued slow growth, we do not believe that conditions warrant a more aggressive risk-off response such as we implemented in late 2007 and 2008. As we have said, the comparisons being made in the media between current conditions and those prevalent in 2008 appear only partially appropriate; we note, for example, that the global financial system is in better shape than it was in the previous period, and that a more robust set of policy tools has been developed to deal with market and financial sector stress. Thus, while it is too soon to foretell outcomes, our bias is to anticipate "muddle through" solutions to the tail risks such that worst-case outcomes are averted.

Municipal bonds

Sharp moves in the Treasury market have been a major driver of recent municipal bond performance. Municipal bonds have performed relatively well versus taxable credit markets as Treasury yields have fallen precipitously on fears of recession, negative outcomes to tail risks, and recent policy action. At the same time, muni performance has lagged that of Treasuries such that yield ratios have widened

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substantially. As a result, we think munis would offer attractive carry versus Treasuries should a low-yield environment persist; they would also offer a spread cushion to help soften the blow to total return in the event that Treasuries back up.

Municipal market technicals remain difficult. New supply has revived (still down 37% YTD versus 2010) without convincing evidence of a resurgence in retail mutual fund flows. In our view, retail investor "sticker shock" in response to low yields could be adversely affecting demand.

The threat of legislative changes to municipal bonds' tax-exempt status — most recently highlighted in President Obama's jobs proposal — is likely to remain a source of volatility for the municipal bond market as the federal government grapples with its troubled debt dynamic. Another aspect of efforts to reduce federal debt is the risk of reduced federal funding of state and local entities, which could lead to more ratings downgrades in the muni sector.

Despite the persistence of factors promoting volatility in the sector, we continue to see good value in municipals for investors with a long-term investment horizon, and we feel that credit quality for the majority of issuers has remained sound. We continue to favor A- and BBB-rated essential service revenue bonds where tax-equivalent yields look particularly attractive versus taxable debt of comparable quality. In our view, essential service revenue bonds may be better positioned than general obligation bonds to weather macro softness and could be less exposed to the risk of federal spending cuts. In terms of curve exposure, we feel the intermediate (10-year) segment is most attractively valued.

Fixed-income indices

Name	1 month	3 months	YTD	1 year
BarCap US Govt Treasury Index	1.75%	6.48%	8.84%	5.97%
BarCap US TIPS Index	-0.24%	4.51%	10.59%	9.87%
BarCap US MBS Index	0.17%	2.36%	5.30%	5.56%
BarCap US Corp Bond Index	0.26%	2.85%	6.10%	4.40%
BarCap US HY Corp Bond Index	-3.27%	-6.06%	-1.39%	1.78%
JPMorgan Global Govt Bond Index	-1.44%	3.06%	7.07%	5.16%
JPMorgan EMBI Global	-4.20%	-1.82%	3.18%	1.28%
JPMorgan GBI EM Global Diversified	-9.83%	-8.55%	-2.22%	-2.60%
BarCap Muni Bond Index	1.03%	3.81%	8.40%	3.88%
BarCap Muni HY Bond Index	1.35%	3.25%	8.40%	4.18%
BarCap US Agg Bond Index	0.73%	3.82%	6.65%	5.26%

Source: SPAR, FactSet Research Systems Inc., as of 9/30/11.

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