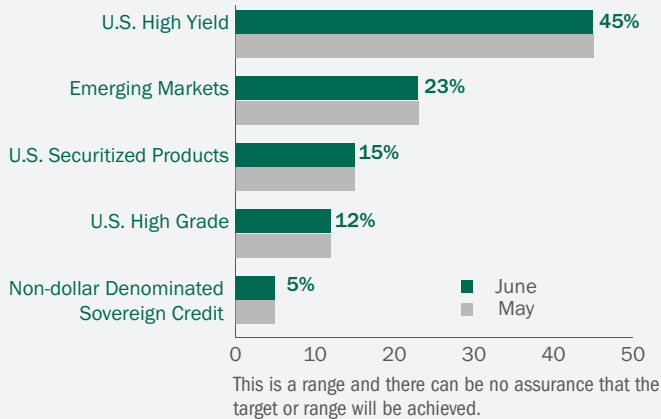


Fixed Income Asset Allocation Notes

JULY 2010

TARGET ALLOCATION

As of July 7, 2010



Economic Overview

Markus Schomer, *Global Economic Strategist*

US

- We have reached a peak in the initial economic recovery and appear headed for the second-half slowdown that we forecasted.
- The inventory cycle is over and consumption is slowing down as households adjust spending to slower income growth.
- Businesses remain extremely cautious on investments and/or payrolls, and government spending is heading lower as state and local governments balance their budgets.

US High Grade

Robert Vanden Assem, *Managing Director, Head of Investment Grade Fixed Income*

Fundamentals

The credit market remains focused on slowing global growth, while financial reform in the US and the sovereign situation in Europe remain concerns as well. However, balance sheets continue to look relatively strong with declining leverage and increased cash on hand. The question that remains is whether or not factors that are currently negatively impacting growth will eventually lead to a double-dip recession. We are neutral on fundamentals and trending neutral.

Valuations

The option adjusted spread (OAS) of the Barclays Credit Index widened 7 basis points (bps) during in June, closing at 179 bps. The index is trading about 25 bps behind its long term average. Financials continue to stand out on a relative value basis and as

- Weaker global growth should weigh on US exports in the coming months.
- We see a period of slower growth in the next three quarters before the expansion can gather steam again by the Spring of next year.
- The June FOMC statement was more dovish than previous ones, introducing “deteriorating global financial conditions” as a new argument for maintaining the low rate commitment.

Global

- Our global growth forecasts remain slightly below consensus.
- Fiscal retrenchment in Europe and a policy induced slowdown in China will likely combine to generate notably weaker growth in the second half.
- Our 2011 forecast is again more optimistic for emerging markets growth, but less so for growth in developed economies, where the effects of fiscal tightening will impact growth prospects more so than in 2010.
- Sweden’s Riksbank is the latest central bank to start the policy rate normalization process, yet the general trend has turned more neutral.
- Most inflation trends are slowing again, providing more cover for central banks to pause or postpone policy-rate normalization.
- We cannot be very confident in our forecast of a first rate hike, as the second-half slowdown and fiscal retrenchment will keep central banks on the sideline for the foreseeable future.
- Further monetary easing so far seems unlikely, unless the risk of a double-dip recession increases.

financial reform becomes clearer, they may be poised to tighten. We are neutral on high-grade valuations and trending positive.

Technicals

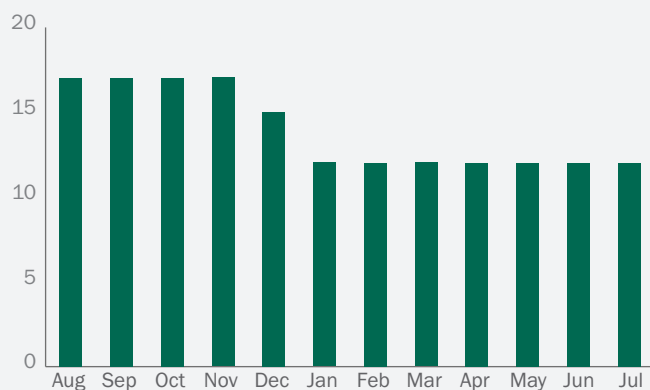
While credit spreads continue to widen, the sharp decline in US Treasury yields has kept absolute yields low. Therefore, credit is less attractive to many balance-sheet investors. Given the Fed’s stance on rates, concern over bank regulation, the situation in the Gulf and in Europe, credit may trade sideways near term. On the positive side, primary dealers have been able to pare down their inventories, leaving them better-positioned going forward. We are negative on technicals and trending neutral.

US High Grade Bonds Allocation Decision:

The broad market remains attractive on a historic basis with select sectors and credits offering value. As strong technicals and external factors continue to dominate, **we will leave our high grade allocation unchanged at 12%.**

TARGET ALLOCATION – US INVESTMENT GRADE

August 2009 – July 2010



US Securitized Products

John Dunlevy, *Managing Director, Head of Securitized Products*

Fundamentals

A conundrum exists for investors as mortgage rates are at all-time lows, yet MBS prices are at all-time highs. The street is having to go back and recalibrate their models to accommodate the lack of refinance activity that is occurring. We are neutral on securitized products fundamentals and trending neutral.

Valuations

The current coupon basis stands at 189 bps, which is 14 bps tighter than last month. The OAS tightened 5 bps to 14 bps. US securitized products had strong performance amongst the massive flight to treasuries. We are neutral and trending neutral on securitized products valuations.

Technicals

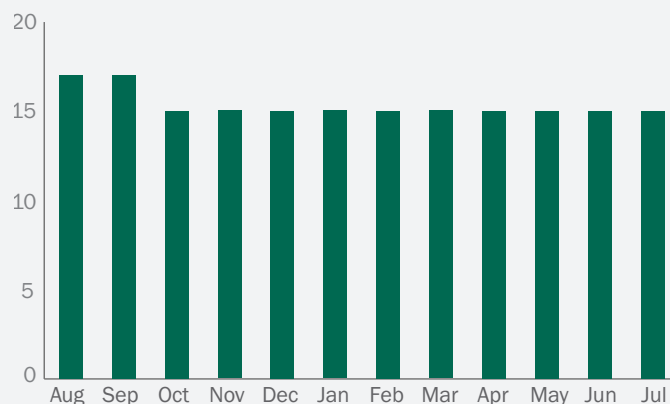
According to a JPM survey, MBS investors are 60% underweight and have been since year end. Yet MBS has outperformed, driven by lack of supply, tighter bank credit, weak housing, stagnant home prices, slower prepaids and an accommodative Fed. We are neutral on category technicals and trending positive.

US Securitized Products Bonds Allocation Decision:

As the flight to quality continues, structured products was able to produce excess returns across all asset classes of 10 bps, 9 bps, and 36 bps for MBS, CMBS, and ABS respectively. We feel we are properly allocated to the category, **so we will keep our allocation to US Securitized Products unchanged at 15%.**

TARGET ALLOCATION – SECURITIZED PRODUCTS

August 2009 – July 2010



Emerging Market Bonds

Rajeev Mittal, *Managing Director, Head of Emerging Market Debt*

Fundamentals

The Chinese economy is coming off the boil, and we expect the economy to grow at a more sustainable pace going forward. We perceive this as a much healthier situation for the Chinese economy, but it may put a dampener on global growth. With the headwinds from fiscal tightening in Europe, economic growth may be generally weaker in six to nine months time. We are negative on EM fundamentals and trending negative.

Valuations

In a roller-coaster month, the JP Morgan EMBI+ widened roughly 15 bps to 340 bps over US treasuries, as EM bonds failed to keep pace with the strong rally in US treasuries. EM credit has lagged US treasuries in spread terms over the last few weeks, but with respect to prices, many high quality/low beta names have seen a higher renewed acceleration. Thus, valuations are not as attractive for those names, while Argentina and Venezuela may still offer some upside, depending on the market's sentiment towards risk. We are neutral on EM valuations and trending negative.

Technicals

The saving grace in June for emerging markets was the strong technical picture. Inflows continue to underpin our markets, and it is hard to see anything that may upset the applecart for the moment. The first half of June was characterized by short-covering as the market's fears of large redemptions following weakness in May were proved unwarranted. We are positive and trending neutral on EM technicals.

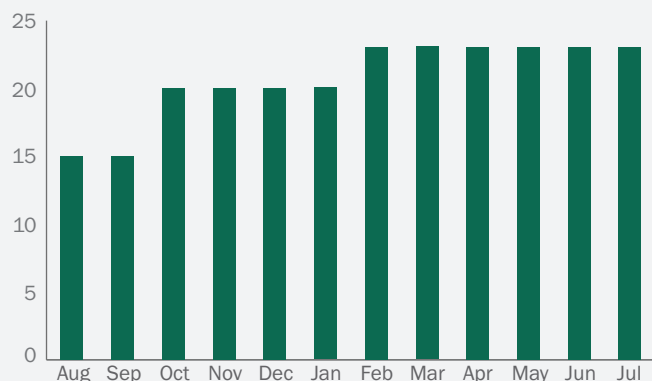
Emerging Markets Allocation Decision

Although EM fundamentals remain strong compared to their G10 counterparts, we are seeing signs of downside surprises to economic growth for the first time in a year. With the Chinese authorities trying to manage a slowdown, the US economy experiencing a jobless recovery and European policymakers administering tighter fiscal policy, there is a risk that we may see weaker growth over the next 12 months. On a positive note, the

technical picture remains strong, and fears of large redemptions in June proved unjustified. We are comfortable with our current allocation to EM, **so we will leave it unchanged at 23%**.

TARGET ALLOCATION – EMERGING MARKETS

August 2009 – July 2010



Non-US Dollar Denominated High Grade Bonds

Anthony King, Managing Director, Non-Dollar High Grade Fixed Income

Fundamentals

The key theme is segregation of near-term growth momentum versus a weak fundamental backdrop for the eurozone. Bank stress tests, sovereign credit risk and long-term centralized fiscal policy, are all key drivers. The manufacturing picture in Japan is receiving downward forecast revisions although with 2-year note yields at 0.15%, rate differentials remained pressured from the US angle. We are neutral on non-dollar fundamentals, and the outlook is negative.

Valuations

Policy-rate changes are being synchronously priced, highlighting forward looking uncertainty. Recently more aggressive Canadian/Australian rate profiles have rescinded, with yield curves flattening at the long end rather than the front end. We are neutral on category valuations, and the outlook is trending negative.

Technicals

Positioning support for the euro emerged loud and clear last month, with the yen and swiss franc benefiting from increased risk aversion. The dollar trade weighted index's (TWI) primary uptrend has not yet been challenged. Cyclical foreign exchange positions are overweight but still around one third of their speculative recent highs. We are positive on non-dollar technicals, and trending positive.

Non-US Dollar Denominated Bonds

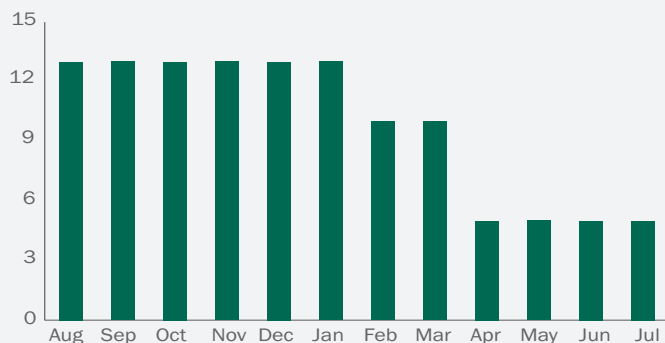
Allocation Decision:

Questioning of the US growth outlook is leading to turbulence in pro-growth currencies. The current macro picture places question

marks over pro-cyclical currencies, although the US is still better placed within the G3. Eurozone policy "attraction" of a weaker currency supports a lower Euro. We feel we are positioned properly in the category, **so we will leave our non-dollar allocation unchanged at 5%**.

TARGET ALLOCATION – NON-DOLLAR DENOMINATION

August 2009 – July 2010



US High Yield

John Yovanovic, Managing Director, High Yield Bonds

Fundamentals

Our stance on fundamentals is unchanged as we wait for second quarter earnings. Balance sheets remain in good shape due to repair over the last four quarters. We expect results to be good, but guidance to be tepid. We are neutral and trending positive on high yield fundamentals.

Valuations

Spreads have retraced all the way back to 2009 levels of 699 OAS with a first half return of 4.51%. High yield credit has likely established this year's trading range (700-550 bps) and looks inexpensive again due to solid fundamentals and low default rates. We are positive and trending neutral on high yield valuations.

Technicals

Technicals were mixed this month due to big coupon inflow and record AMG-reported inflow in third week of month, partially offset by equity volatility. Primary issuance fell again to around US \$7 billion for the month, bringing it to US \$117.8 billion year to date. Cash levels normalized, still seeing better buyers of quality credit but supply/demand balance remains fragile. We are neutral on high yield technicals, but the outlook is volatile.

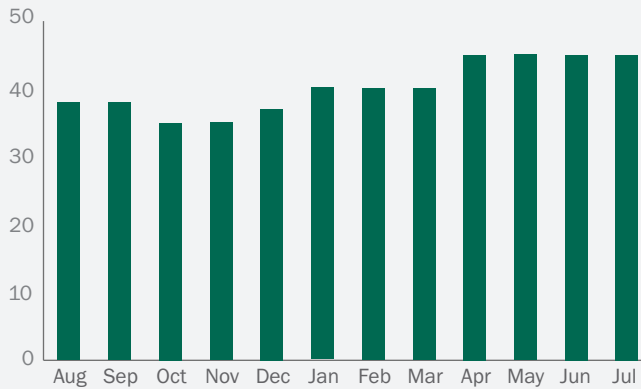
High-Yield Bonds Allocation Decision

June saw volatile price action due to equity volatility and valuation remains near December 2009 levels. New issues picked up but still were below pace. We expect second-quarter earnings releases to be positive, but the outlook seems

moderate. Spreads are range bound and current yield will be a much bigger component of return going forward. **We will keep our allocation to the category unchanged at 45%.**

TARGET ALLOCATION – HIGH YIELD

August 2009 – July 2010



Leveraged Loans

Julie Bothamley, *Managing Director, Leveraged Loans*

Leveraged Loans are part of the monthly allocation discussion. Allocations are made for those portfolios that follow the allocation guidance at client request.

Fundamentals

First quarter earnings are in-line with or better than expectations. We are positive on leveraged loan fundamentals and trending neutral.

Valuations

Maturity extension amendments continue to drive up current yield. June price retrenchment further increased the attractiveness of loans. Leveraged loan valuations are positive and trending neutral.

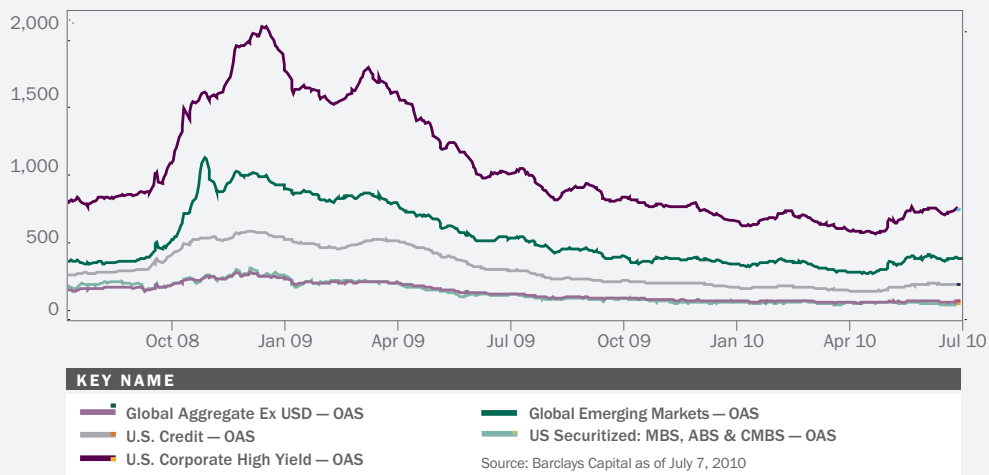
Technicals

Fund outflows during the month coupled with lower refinancing activity reduced demand. New issue volume continued, albeit at a slower pace, despite widening spreads. We are neutral on leveraged loan technicals and trending positive.

Leveraged Loans Summary

Fundamentals remain stable. Negative fund flows drove a decrease in demand and slight price retrenchment in June. Valuation remains attractive.

OPTION ADJUSTED SPREAD (OAS)



Past performance is not indicative of future results.

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