

Market Update

Overview

The positive momentum in the markets at the time of our last update has abated as sentiment waned in late April as rising concerns about euro area sovereign debt came to the fore.

Growing uncertainty over the condition of Greece's public finances and mounting liquidity driven fears sparked a general sell-off. Volatility returned and elevated risk aversion drove demand for safe haven assets - 10 year bund yields briefly fell to 2.49%. Successive downgrades to Greece, Portugal and Spain and lack of a decisive and unanimous response to the escalating default worries from the region's leaders further intensified fears over debt contagion. Spreads of the highly-indebted countries have climbed to record highs while confidence in the Euro plummeted.

The subsequent EU-IMF announcement of a €750bn aid programme provided short-term relief to distressed markets. Liquidity concerns have eased on robust fiscal aid along with a reintroduction of the unconventional measures by the ECB (sovereign debt purchase, longer-term refinancing operations, dollar liquidity swap lines with the Federal Reserve). However concerns regarding Sovereign solvency risk have not abated. While new austerity measures have been announced by perceived weaker European countries, sovereign credit spreads have retraced some of the initial gains as the market remains sceptical of the likelihood of implementing the measures required to contain public finances.

As the sovereign debt crisis dominated the headlines, overall solid Q1 corporate results and largely positive macroeconomic data had little impact on the market performance.

Key US economic indicators have improved since the last update - the private sector posted its 5th consecutive month of jobs growth while home sale volumes have bounced from the February low. In the latest Fed report, economic activity showed modest growth across all districts.

Eurozone economic data produced mixed results. While business conditions have improved in core economies, consumer spending remains weak and

unemployment high. Fiscal cuts will further impede growth prospects. Eurozone economies stand to profit from the weak currency as the Euro is trading at multi-year lows.

Despite more positive economic readings, the global economic outlook remains uncertain as the recovery still faces significant headwinds - high debt burden, budget constraints, high unemployment and ample spare capacity.

Central banks' key rates are expected to stay unchanged at historical lows for the rest of the year as inflation stays subdued while the downside risk to the recovery story has increased.

ABS Market Overview

Liquidity concerns and sovereign credit risk have dominated the ABS market in a relatively subdued quarter.

ABS credit spreads lagged the broader credit markets and displayed some initial resilience to the market correction triggered by concerns over sovereign credit risk. This was short lived and the ABS market subsequently softened. Secondary market trading volumes also declined as negative sentiment took hold. Primary issuance remained sporadic throughout the second quarter, largely restricted to the better performing asset classes including Dutch & UK Prime RMBS and supported in many cases with preplaced tranches.

In terms of regulation, the European Commission recently published a proposal similar to the SEC rule 17g-5 aimed at improving the supervision of credit rating agencies (CRA's). Amongst other proposals, ABS issuers would be required to furnish all interested rating agencies with access to the information they give to their own CRA so that unsolicited ratings could also be issued.

The new rules are designed to promote greater risk management and increased transparency within the industry. If adopted, the rules will come into effect in 2011.

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US ABS

Our expectation for further negative rating action within the private label Student Loan sector materialised this quarter, with rating agencies identifying weaker than expected collateral performance as a primary motive for transaction downgrades.

In the Alt-A RMBS sector, more seasoned vintages continue to show moderate improvements in delinquency and default rates however loss severities, although stabilising, remain close to record highs for all vintages. Voluntary prepayment rates across all vintages remain unchanged this quarter, firmly anchored between two and five percent. Improvements in delinquency rates are being reported within the Sub-prime RMBS sector, which may be benefiting from the Home Affordable Modification Program's efforts to increase the volume of loan modifications it is completing.

Rating agency downgrades have continued across all Alt-A RMBS tranches and vintages, albeit at a slower pace when compared to the first quarter. We anticipate that pre 2006 Alt-A RMBS which have not experienced the same magnitude of ratings downgrades as more recent vintages will remain under rating pressure, despite recent indications of stabilisation in collateral performance.

European ABS

Sovereign developments have impacted on European ABS credit spreads this quarter as peripheral spreads widened relative to other core markets. Agencies downgraded SME ABS, Consumer ABS and RMBS securitisations originated in Greece, Spain and Portugal with negative ratings being driven mainly by weaker than expected collateral performance.

The downgrade of Greek, Spanish and Portuguese debt, combined with the findings of the ECB's semi-annual Financial Stability Report, where it was reported that European banks are facing as much as €195bn in write-downs over the next two

years, further undermined investor sentiment towards European ABS.

UK and European CMBS ratings also came under pressure again this quarter, driven by covenant breaches and agency concerns over refinancing risk. Loan restructurings are continuing to take place against this backdrop of limited refinancing availability, heightened tenant insolvency risk and weak economic conditions which continue to exert downward pressure on rents.

Corporate Credit

Sovereign news flow dictated price behaviour in the corporate credit market. Credit fundamentals remained stable, with few negative earnings surprises or unexpected rating migration.

It has been a difficult quarter as spreads widened significantly and the European new issue market was effectively closed for business for much of the period.

Risk aversion has led to a flattening of credit curves. Anecdotal evidence suggests many funds are stockpiling cash in anticipation of investor redemption requests - the opportunity cost of staying on the sidelines is low at current yields. Most corporates have pre funded their maturing debt for 2010 and are expected to be able to withstand a sustained period of low activity in the primary cash market.

At the time of writing investor sentiment was improving and there were tentative signs of decoupling of sovereign and credit spreads. Nevertheless we expect the traditional summer lull in activity to exacerbate spread volatility and news flow from other markets to dominate.

Hedge Funds

Investors were presented with countervailing performance over the first five months of the year and the frailties of the global recovery are obvious for all to see. Markets were largely flat for April, losing the early momentum from the pro risk sentiment in February and March. Hedge funds have been adversely affected by the

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growing seriousness of the Euro Sovereign bond crisis. May was the worst performing month since November 2008 with majority of strategies surrendering many of the gains made in the earlier months of 2010. The HFRI Weighted Composite Index declined by 2.26% in May however it still remains net positive for the first five months with a gain of 1.32%.

The industry is still experiencing net inflows of funds, but they remain relatively small and while it is expected that inflows will continue for the remainder of the year, they are likely to be a small percentage of the \$1.67trn market. \$13.7bn of capital inflows were generated in Q110.

Increased regulation is a recurring theme in the hedge fund market in recent months. The US government and the European Parliament are proposing to introduce a series of measures to increase regulation, transparency and liquidity, restrict leverage and move from off-shore to onshore vehicles. One such proposal by the European Parliament would require fund managers outside the European Union to follow EU rules before being allowed to market funds in Europe. One of the US government proposals is to charge higher tax rates on the performance fees generated by fund managers. The final proposals will be approved in the coming months and could have significant implications for the industry.