

Market Update

Overview

Financial markets continued to recover in the first quarter of 2010. Early gains gave way to a sell-off in mid/late January but positive momentum was regained towards the end of the quarter. Following the stellar market performance last year, markets came under pressure in late January due to rising concerns over Chinese policy tightening, European sovereign debt and the level of government intervention in the financial sector. These concerns waned as markets rose on the back of better than expected fourth quarter earnings.

Key US economic indicators provide mixed signals - the labour market shows some signs of stabilisation but home sale volumes and prices have recently weakened.

Eurozone unemployment remained high as corporate investment and household spending fell. Economic recovery may become more vulnerable as the effects of fiscal stimuli begin to fade. This risk is exacerbated by the growing concerns over fiscal deficits that will constrain further government intervention.

Increasing awareness of Greece's current account deficit, short term financing needs and internal political strife sparked a sell off across asset classes. Though initial concerns have softened, disagreement over the appropriate support Eurozone members should provide has undermined confidence in the Euro and driven spread widening across several fixed income markets.

Central banks have started to withdraw their extraordinary liquidity facilities as financial market conditions improve while the official lending rates remain at historic lows. Key rates are expected to remain unchanged for much of the year as inflation is subdued and recovery is slow.

ABS Market Overview

The rally in ABS pricing witnessed in the latter half of 2009 reached a plateau at the beginning of the

year as broader financial market developments impacted on investor sentiment.

Recent weeks have seen an overall improvement in ABS pricing and a general consolidation in spread levels as some new market entrants, particularly investment bank trading desks, bid up the market.

US ABS

Negative rating actions have continued unabated in the US ABS sector with US Alt-A RMBS and private label Student Loan transactions accounting for the majority of downgrades. This has been driven by revisions to the rating methodologies which have been adjusted to incorporate higher loss expectations, particularly in the US Alt-A sector.

Delinquencies and foreclosures in the Alt-A sector remain high but the performance of earlier vintages (pre 2007) shows signs of improvement or at worst, stabilisation. Loss severities across all vintages have also stabilised but at very high levels. Voluntary prepayment rates remain at record lows and are currently running in the low single digits for many deals.

Collateral performance in private label Student Loan ABS has continued to deteriorate, leading to further rating downgrades throughout the capital structure. The introduction of the 'Student Loan Reform' legislation signals a move towards direct lending from the government to the student. It is not envisaged that this legislation will negatively impact on the ratings of existing FFELP Student Loan ABS. However, the servicers and administrators of these programmes may suffer a decline in future revenue streams.

We expect ratings to remain under considerable pressure particularly for more recent vintages.

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European ABS

Volumes in the market have remained resilient, albeit activity has been largely confined to the tranches of the higher yielding assets classes including UK Non-Conforming RMBS, UK CMBS and Spanish Prime RMBS.

Rating pressure on the European ABS market in 2010 is focused on specific sectors such as UK & European CMBS, Spanish Prime RMBS, Spanish SME and Italian Leasing ABS. The RMBS market in Spain continues to under perform relative to other European RMBS markets however the pace of deterioration has slowed in recent quarters as short-term arrears begin to show tentative signs of stabilisation. Rating actions have also been witnessed in other European asset classes including Spanish SME's and Italian Leasing ABS deals which were originated at the peak of the credit boom.

Despite a strong improvement in UK commercial property values in the latter half of 2009, UK CMBS transactions continue to experience multi-notch downgrades driven mainly by covenant trigger breaches and loan level payment defaults. Refinancing risk remains the key driver of rating agency actions though this risk is mitigated in certain deals where extensions to the expected loan maturity date have been agreed. We expect restructurings incorporating features such as loan extensions coupled with scheduled amortisations to become more prevalent in the UK and European CMBS sector as the market addresses the outstanding balance of loans scheduled to mature in the next four years.

MBNA's announcement that it would support its UK CARDS Trusts through the issuance of an additional series of subordinated notes which effectively increased the credit enhancement levels for all outstanding issuances had a positive impact on the Credit Card sector.

Corporate Credit

During the first quarter of 2010 corporate credit markets consolidated gains made in 2009. The early new year investor demand that drove spreads

tighter was followed by a sell off as Chinese liquidity and European sovereign risk concerns took hold though as those fears fell the market has gradually recovered to end the quarter broadly unchanged. The restoration of cash / CDS basis levels to pre crisis levels is a further indicator of a normalisation in credit markets.

Following last year's record level of new issuance the cash market has been relatively quiet with quarter 1 European non-financial issuance down over 60% from the same period in 2009. High grade corporate issuers were generally fully funded coming into 2010 and issuance has been focussed on the lower quality credits that have availed of the investor demand for cash product. In the synthetic market CSO unwinds have increased as original Note holders sell in to a strengthening market and banks are motivated to cut their risk positions in response to the proposed Basel II changes to capital weightings. The most recent earnings season ended with few negative surprises and CDS credit events have been limited to well flagged distressed companies (e.g. FGIC).

The CDS market faces an uncertain future as the political will to restrict the market grows with some politicians proposing an outright ban on naked short CDS. Regulators are forcing more transparency on the sector and further restrictions on market participants may follow.

The historic market highs reached during 2006/2007 were artificially created by high system leverage from off balance sheet vehicles and are unlikely to return. Current market drivers remain largely supportive (continuing investor demand, few negative earnings surprises, low supply) but we do not expect spreads to tighten substantially from this point. Concerns about sovereign current account deficits and confusion over a Eurozone response to member's rising debt levels are likely to continue to dominate market sentiment.

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Hedge Fund Industry Update

Following the strong performance in 2009 (+20%), the hedge fund industry produced a mixed performance for the first two months of 2010 (-0.1%). The year started where 2009 had left off, as global equity markets continued to rally, however by the end of January there was a significant sell off similar to the ABS and corporate credit markets. Equity markets continued to sell off in early February feeding into the performance of the Hedge Fund industry (correlation 0.77), however by the end of February markets had rebounded, benefiting from strong corporate earnings and the belief that some of the previously mentioned concerns were abating. The positive momentum has continued into March and there are strong indications that the industry will yield a positive return for the month.

Over the past twelve months managers with a Short Bias have considerably underperformed the rest of the industry while Emerging Market managers along with managers in the Convertible Arbitrage space have significantly outperformed.

While uncertainty remains to the extent and timing of the global recovery, hedge funds continue to see positive net flows into the sector. Net asset flows were positive to the tune of approximately \$4.3bn for February bringing total assets under management back to \$1.5trn. The industry is expected to continue to see further inflows throughout 2010; however it may not be a smooth growth trend as the market remains somewhat cautious.