PINEBRIDGE INVESTMENTS

MARKET COMMENTARY

Fixed Income Asset Allocation Notes

August 2013

Economic Overview

Markus Schomer
Managing Director, Chief Economist

Base Case

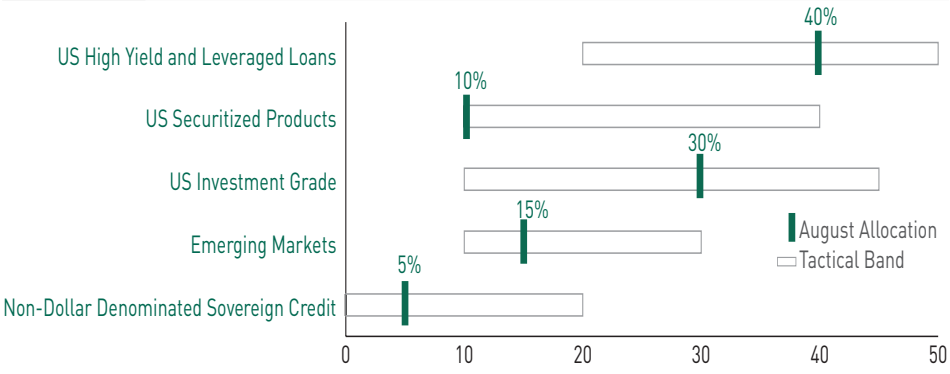
- We see moderate GDP growth in the 2.5% to 4.5% range.
- We see the US improving gradually and remaining the key driver of the global business cycle.
- Japan growth is stronger on more Abenomics stimulus, but quantitative easing (QE) must be increased and a premature sales tax hike avoided to sustain the growth.
- There is a gradual resumption of growth in the eurozone, and second quarter data indicated that the double-dip recession is over and Europe is no longer a drag on global growth.
- Growth in emerging markets (EM) will be led by Asia, with Latin America and Eastern Europe lagging.
- US bond yields put pressure on currencies in countries with sizable current account deficits like India, Indonesia and Turkey.
- Consensus 2014 GDP forecasts remain just below 3% with a gradual acceleration to 3.2% in 2015, well within our base case.
- Risks include the possibility of premature stimulus withdrawal in the US and Japan, lack of growth follow-through in Europe and EM current account crisis, particularly in India.

Summary Portfolio Allocation Decisions

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

We are leaving our portfolio allocation unchanged. Our wait-and-hold stance is primarily a result of the continued market volatility surrounding the Federal Reserve's Federal Open Market Comittee (FOMC) meeting in mid-September and the overall market expectation of additional transparency with respect to the Fed's tapering plans coming out of the FOMC release. We do not discard an intramonth action if markets react substantially to political and economic events that support additional selective risk-taking.

FIGURE 1 Target Allocation
As of 21 August 2013



This is a range and there can be no assurance that the target or range will be achieved.

US Investment Grade

Dana Burns, *Managing Director, Investment Grade Fixed Income*

Fundamentals

Despite decent second quarter earning results, management teams continue to show a willingness to increase leverage targets in order to fund growth strategies and return capital to shareholders.

Valuations

The recent widening in credit spreads and the backup in rates has made all-in yields more palatable. Thin August trading and the potential for supply in September gives us pause.

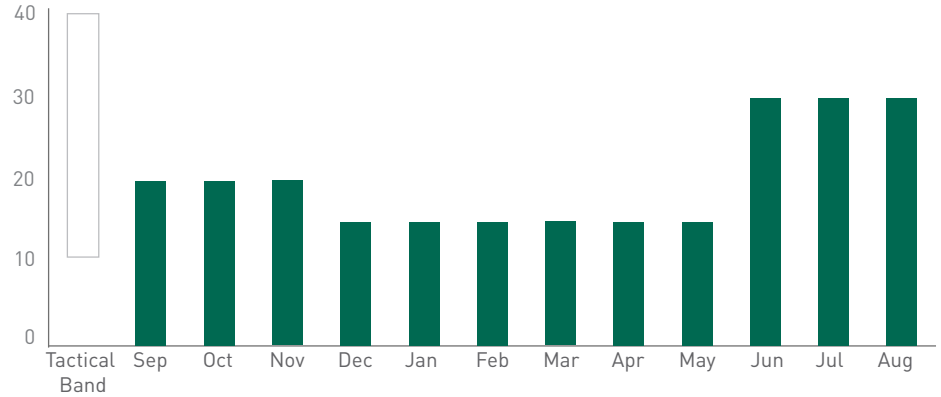
Technicals

The recent backup in rates has led some buyers of credit back into the market, but uncertainty surrounding Fed activity and the direction of interest rates continues to pressure demand.

US Investment Grade Bonds Allocation Decision

We kept duration in line with benchmark, given our view that rates are likely to remain volatile until market participants have clarity on Fed tapering and the economy. **We are comfortable with our current allocation and will leave it unchanged at 30%.**

FIGURE 2 Target Allocation: US Investment Grade
September 2012 — August 2013



Securitized Products

***Andrew Budres**, Senior Vice President, Securitized Products*

Fundamentals

The next 100 bps of spread widening upward has less affect than the previous 100 bps.

Valuations

Spreads are now fully baking in zero Fed sponsorship.

Technicals

Tapering is the source of volatility right now.

US Securitized Products Allocation Decision

We are adding more 15-year paper, but the market is still too choppy to be tactical. Also, the volatility makes the timing difficult. **So, we will leave our securitized products allocation unchanged at 10%.**

Non-US Dollar Denominated High Grade Bonds

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

Fundamentals

The relative economic picture is surprising to the upside in the eurozone and UK, with the former pushing back on further policy easing. Japan is broadly proceeding as expected, albeit with further structural progress to be made ahead. Latent political risk (Italy) and austerity "fatigue" (Spain) remain in the background. EM weakness may feed back into the euro area's export demand.

Valuations

While valuations are attractive in the minor G10 space, short maturity interest rate differentials continue to move in favor of the US — keeping the dollar supported in the medium term.

Technicals

There is a tight channel for the trade-weighted dollar index, with 84 as the upside target. Investor positioning metrics remain solidly net long dollar, long euro and yen close to neutral.

Non-US Dollar Denominated High Grade Allocation Decision

We feel that the non-dollar portion of the portfolio should remain underweight. **We will leave the allocation unchanged at 5%.**

Emerging Markets

***Steven Cook**, Managing Director, Emerging Markets Fixed Income*

***Anders Faergemann**, Managing Director, Emerging Markets Fixed Income*

Fundamentals

Sovereigns: Fears that the Chinese economy was headed for a crash landing were put to rest by slightly better China data in recent weeks. Taken in combination with the improvements in euroland, this should provide some optimism for EM, but it seems to be too early to tell yet.

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FIGURE 3 Target Allocation: Securitized Products
September 2012 — August 2013

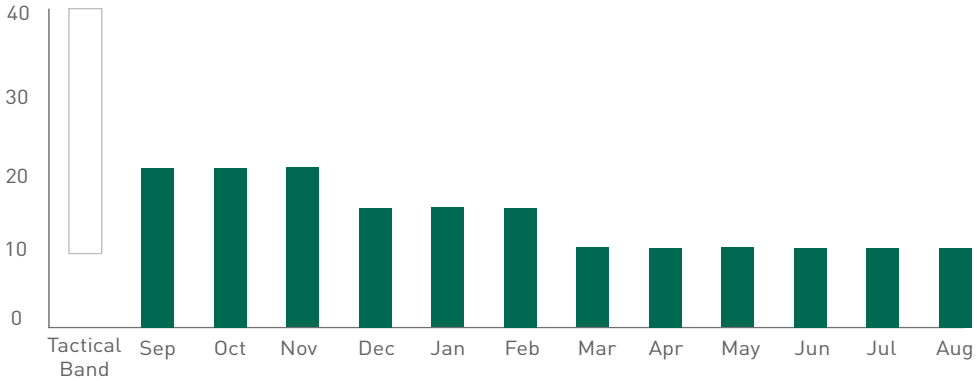
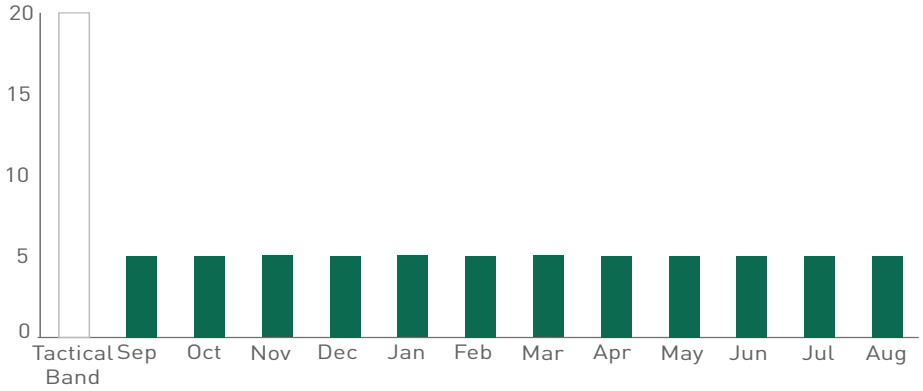


FIGURE 4 Target Allocation: Non-Dollar Denominated Sovereign Credit
September 2012 — August 2013



Corporates: EM corporate fundamentals continue to be in better shape than many developed markets, with the exception of a few idiosyncratic cases. With most of the issuers having addressed their refinancing risk recently, debt maturity profiles look favorable.

Valuations

Sovereigns: EM hard currency bond spreads are caught in a fairly narrow range between 300 bps and 340 bps over US Treasuries, leaving the market undecided on its next move. The high yield sector continues to outperform investment grade, but general valuations are not yet sufficiently attractive to look inviting for crossover investors.

Corporates: EM corporate spreads were more or less flat, ending the month at 344 bps versus 350 bps in June. New issuance continued to be scarce. With high yield spreads trading around 500 bps to 550bps, default expectations remain relatively low (JP Morgan's HY expectation is 3.8% for 2013).

Technicals

Sovereigns: Although outflows have decelerated since the June capitulation, there have been no signs of retail flows returning, leaving the asset class vulnerable to institutional flows going forward.

Corporates: Higher US Treasury rate forecasts have diminished expectations for EM corporate returns for the year. Meanwhile, outflows from the asset class have diminished.

Emerging Markets Bonds Allocation Decision

We currently stand at 65% external debt, 10% local currency and 25% corporate. **We will leave our allocation unchanged at 15%.**

US High Yield and Leveraged Loans

John Yovanovic, *Managing Director, High Yield Bonds*

Julie Bothamley, *Managing Director, Leveraged Loans*

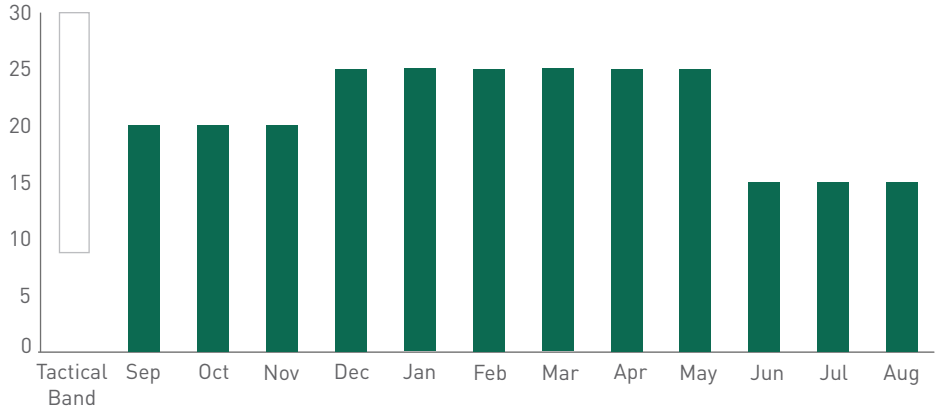
Fundamentals

Earnings and macro conditions continue to be in line with expectations. Covenant-lite issuance is reaching cycle highs, but over 60% of issuance is for refinancing. Leverage is near historic norms and cash balances are heading lower from historic highs. Markets are ripe for LBOs, but they are still a small part of the picture to date.

Valuations

Spreads are at Treasury+455 bps for high yield and LIBOR+469 bps for leveraged loans. Our 2.0% 2012 default forecast leads to fair value

FIGURE 5 Target Allocation: Emerging Markets
September 2012 — August 2013



range of 390 bps to 490 bps for high yield. The current spread implies a 2.1% to 3.8% default rate.

Technicals

We are seeing volatile flows for high yield and inflows for loans. Plus, we see continued demand for loans. Traditional high yield investors are wary of extension trades.

US High Yield and Leveraged Loans Summary

After recent changes, we are comfortable with our allocation and will leave it unchanged at 40%. ■

FIGURE 6 Target Allocation: US High Yield and Leveraged Loans
September 2012 — August 2013

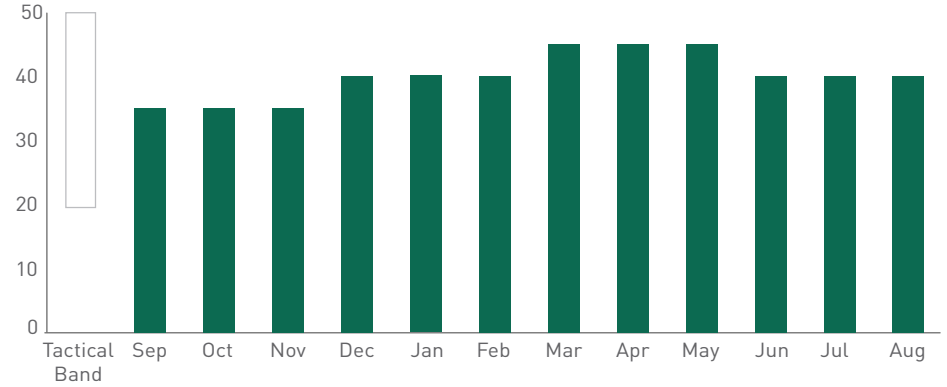
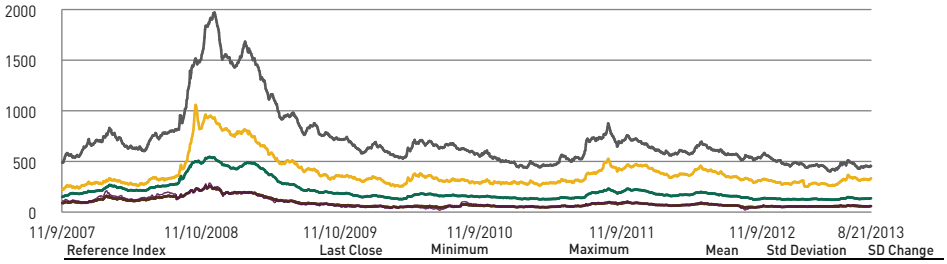


FIGURE 7 Option Adjusted Spread (OAS)
As of 21 August 2013



Reference Index	Last Close	Minimum		Maximum		Mean	Std Deviation	SD Change
US Credit	136	121	14-May-13	545	3-Dec-08	205	108	3
High Yield Corporate	453	402	10-May-13	1,971	16-Dec-08	727	334	13
US Securitized (MBS, ABS, CMBS)	61	17	27-Jul-10	289	3-Dec-08	83	50	5
Global Emerging Markets (USD)	334	251	11-Mar-13	1,058	27-Oct-08	401	162	9
US Aggregate	58	44	27-Jul-10	258	3-Dec-08	84	48	2

Source: Barclays Capital

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