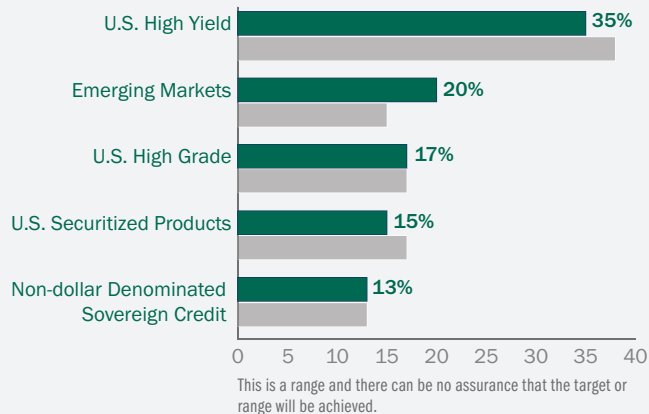


# Fixed Income Asset Allocation Notes

OCTOBER 2009

## Target Allocation

(As of October 7, 2009)



## Economic Overview

Markus Schomer | Global Economic Strategist

### U.S.

- Data continues to support our forecast of a vigorous rebound in economic activity in the U.S. in the second half. We have raised our third-quarter GDP growth forecast to 5%. The consensus now stands at 2.9%, up from 0.5% as recently as June.
- CARS (a.k.a. "Cash for Clunkers") and the First Time Home Buyer Credit have made an impact on the economy. The former has expired, but significantly boosted consumer spending in the third quarter. The latter stimulated a strong rebound in home sales, stabilizing the construction sector.
- Labor markets remain the key resistance to a sustainable rebound. However, we still expect businesses to start hiring again soon, if only to restore payrolls to levels consistent with even a slow recovery.
- The key question is the durability of the current rebound, given lingering problems in the U.S. banking sector and the time it will take to address the high unemployment levels. We are still looking for a double-dip slowdown next summer.

### U.S. High Grade

Robert Vanden Assem | Managing Director, Head of Investment Grade Total Return Portfolio Management

### Fundamentals

For high grade corporates, the most recent economic data has been disappointing and points towards a slower economic recovery. Last week, both the Institute of Supply Management (ISM) report on business activity and the employment report were weak, demonstrating that the economic environment remains challenged. We are negative and trending neutral on high grade fundamentals.

- The past few FOMC meetings have resulted in moderate upgrades to the Fed's assessment of the economy. Opinion on rates remains mixed. Some senior officials arguing for rate hikes "sooner rather than later," while others remain dovish on rates.
- We feel that January is ripe for a first move in rates, which would still leave policy extremely accommodative.

### Global

- Purchasing Managers Indices have confirmed our view that the manufacturing momentum in Europe is lagging other regions
- The coming quarters will depend on the path of unemployment and its impact on consumer spending. Europe is likely to lag again, with unemployment expected to trend higher through most of next year.
- Government spending will remain an important source of growth, but growth rates will depend on the ability to address ballooning fiscal deficits in the coming years.
- Australia became the first of the G20 economies to raise interest rates. Along with improvement in Japan's industrial activity, this underscores the positive impact of China's faster growth on its key trading partners.
- Australia's justification was an improving economic backdrop, monetary policy that will remain stimulative and the diminished threat of sliding into another Great Depression.
- Australia has a stronger economy than most other developed markets, but the Reserve Bank of Australia clearly decided to stay ahead of the curve.
- However, this is not yet the start of a broader based monetary policy tightening. Europe's economies are lagging and there is a chance the Bank of England might yet increase its asset purchase program, while Japan is again facing full-blown deflation. We still expect the Federal Reserve to be the next mover among developed world central banks.

### Valuations

The option adjusted spread (OAS) of the Barclay's Credit Index tightened by 12 basis points in September, closing at 198 basis points. Year-to-date, excess return for the Credit index is 17.12%. Life Insurance was the top-performing sector, after lagging the broader index for most of the year. On the whole, high grade corporate credit appears to be at fair value across much of the spectrum. We are neutral on category valuations, but the outlook is trending negative.

## Technicals

Supply is expected to remain subdued as we enter the earnings season, which may take secondary spreads tighter, given the strong demand from large institutions. There are two opposing forces currently at work in credit markets; balance sheets and total return managers. Many total return and hedge fund participants are looking to lock in this year's strong market performance, while large balance sheet players still have a great deal of cash to put to work.

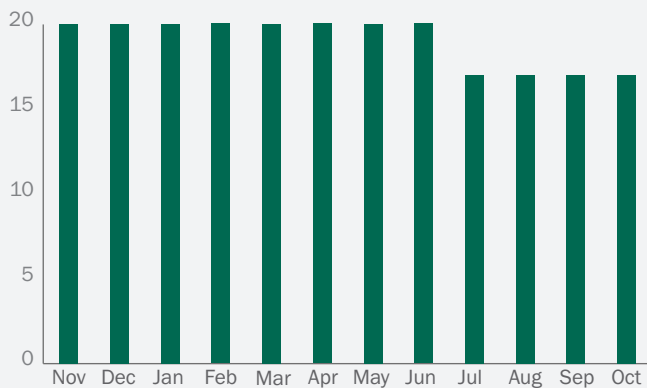
In the short term, this could make for some choppy markets. However, longer term, balance sheet demand should win and move spreads tighter into year end. We are neutral and trending positive on high grade corporate technicals.

### U.S. High Grade Bonds Allocation Decision:

The broader market remains attractive on a historic basis, even though many sectors have reached fair value. However, increased profit-taking and economic uncertainty are likely to counter strong cash driven demand, so we will leave our **high grade corporate allocation unchanged at 17%**.

### Target Allocation – U.S. Investment Grade

(November 2008 - October 2009)



## U.S. Securitized Products

John Dunlevy | Managing Director, Securitized Products

### Fundamentals

Despite the rally in rates driving 30-year mortgage rates lower, the prepayment response has been muted, due to a weakened borrower base. Mortgage borrowers continue to be adversely impacted by weaker housing prices, uncertainty on the employment front, and tougher loan underwriting standards.

Loan modifications under the Home Affordable Modification Program (HAMP) remains a significant concern for high-premium coupons, especially given the poor borrower profiles in those pools. Participation has been widely varied among servicers, which could lead to potentially higher risk with TBA delivered pools. Thus we see increased value in non-TBA specified premium priced pools. We are negative and trending neutral on securitized product fundamentals.

## Valuations

Valuations again improved modestly over the last month, as the decline in volatility made mortgages look more attractive to OAS buyers. They continue to look relatively expensive on a historical basis, though there really is no historical precedent for \$1.25 trillion in manufactured Fed demand. If the Fed remains committed to at least absorbing net issuance, spreads should remain firm, but if the Fed starts extricating itself from the role of active buyer, spreads will head wider. We are neutral on securitized products valuations.

## Technicals

Technicals continue to be the dominant force behind the mortgage market, as the Fed's MBS purchase program has absorbed more than 250% of net issuance over the past nine months. The latest FOMC statement dispelled any uncertainty about the eventual wind-down of the purchase program.

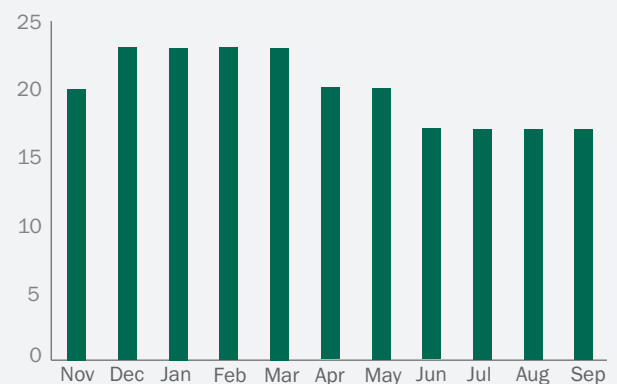
The Fed is now committed to purchasing the full \$1.25 trillion, and will extend the program three months through March 31 of 2010. With the overwhelming support of the Fed, it is unlikely the mortgage basis will widen dramatically in the near term. We remain positive on category technicals.

### U.S. Securitized Products Bonds Allocation Decision:

Continued Fed support and declining realized volatility should keep performance in line with Treasuries in the short term, but to take advantage of opportunities in other subasset classes, we will **reduce our allocation to U.S. Securitized Products by 2%, bringing it to 15%**.

### Target Allocation – Securitized Products

(November 2008 - October 2009)



## U.S. High Yield

John Yovanovic | Managing Director, High Yield Bonds

### Fundamentals

The landscape remains unchanged as we await third quarter earnings. Fundamentals remain better at the margin, due mainly to cost-cutting, while revenue gains are due to either commodity strength (Metals) or a bounce off of the severe declines of the past three quarters (Gaming, Lodging, Technology, Autos, etc.). We are neutral and trending positive on high yield fundamentals.

## Valuations

High yield spreads tightened 91 basis points to 763. Credit is at fair value, depending on the default outlook, but continues to look inexpensive relative to other risk asset classes, due to current income. We are positive, but trending neutral on high yield valuations.

## Technicals

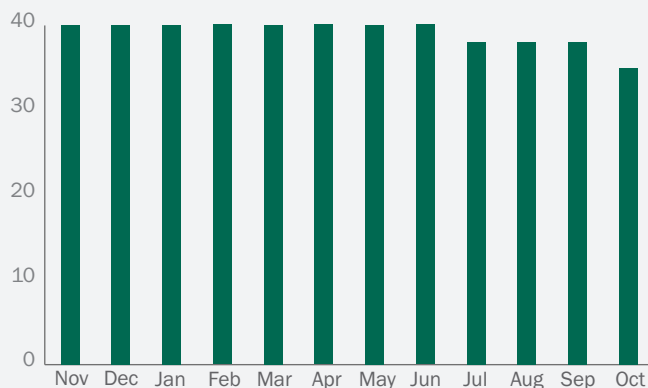
Primary issuance was lower than expected during the month. Combined with institutional and retail demand for paper, technicals were unexpectedly strong. This strength was supported by the fact that multiple strategists reduced their 2010 default forecasts to 4%, resulting in spread levels appearing cheap versus the old 6% forecast. We are positive but trending neutral on high yield technicals.

## High-Yield Bonds Allocation Decision

High yield posted a strong month to end a strong quarter. Spread tightening continued due to technicals. We expect spreads to continue to grind tighter, as long as equity volatility remains muted, but to take advantage of opportunities in other subasset classes, we **will reduce our allocation to high yield by 3%, bringing it to 35%.**

### Target Allocation — High Yield

(November 2008 - October 2009)



## Emerging Market Bonds

Rajeev Mittal | Managing Director, Head of Emerging Market Debt

### Fundamentals

A V-shaped recovery has been discounted in China, but as the growth is predominantly domestic-demand-driven (government induced), it is not lending much strength to the rest of Asia. Nevertheless, Asia is still showing firmer signs of recovery than the other EM regions, and central banks, such as the Bank of Korea, may be among the first to raise interest rates. The decline in the yield differential between Asia and Central Eastern Europe, Middle East and Africa (CEEMEA) is another factor that should support Asian foreign exchange, and we expect these currencies to outperform the CEEMEA currencies in the final quarter of the year. We are positive on category fundamentals, and the outlook is neutral.

## Valuations

EM credit remains firm, though spreads have widened since hitting almost 300 in the middle of September. Several central banks have signaled their dislike of further currency appreciation. We are negative on EM valuations, and the outlook is neutral.

## Technicals

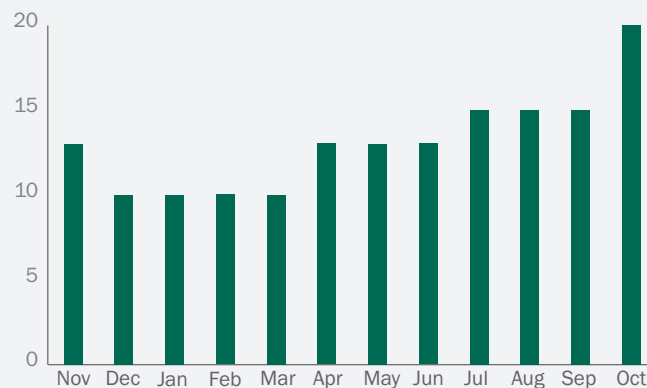
New issues have been a bit of a mixed bag, suggesting that market participants have less cash available and will be more price-sensitive going forward. Hedge funds took profits in August and are likely to stay on the sidelines for the remainder of the year. Banks are likely to start positioning for year end, leaving real money investors to hold the key to the next directional trend. We are neutral, but trending positive, on EM technicals.

## Emerging Markets Allocation Decision

Heavy inflows into the asset class helped Emerging Markets rally in September. The weaker U.S. dollar in September underpinned the rally in EM foreign exchange, but several EM currencies struggled against the euro and the yen, raising questions about how much further EM currencies can strengthen. However, we see many attractive opportunities in this space, and we **will raise our allocation to EM by 5%, bringing it to 20%.**

### Target Allocation — Emerging Markets

(November 2008 - October 2009)



## Non-U.S. Dollar Denominated High Grade Bonds

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

### Fundamentals

The near-term risk appetite driver is beginning to be shadowed by attractive valuation measures. The dollar remains supported by high levels of foreign participation at Treasury auctions. While the yield curve remains steep, inflation breakevens are at historically average levels, indicating little external pressure on the dollar. The nature of the exit from Quantitative Easing (QE) in 2010 remains critical, and early non-QE leaders Australia and Norway are set to tighten before year-end. We are positive on non-dollar fundamentals, and the outlook is stable.

## Valuations

The dollar has improving support from pure valuation measures, but must see a reversal in (declining) yield differentials before recording an outright positive from valuation. We are negative on category valuations, and the outlook is also trending negative.

## Technicals

The broad trade weighted index continues to bounce off of the 61.8% retracement of the dollar's March highs. Real money investors are broadly neutral on the dollar, while speculative investor surveys remain short on the dollar but far from extended. We are neutral on non-dollar technicals, and the outlook is stable.

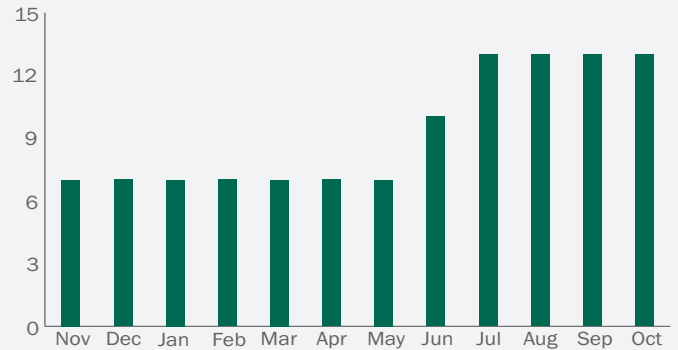
## Non-U.S. Dollar Denominated Bonds

### Allocation Decision:

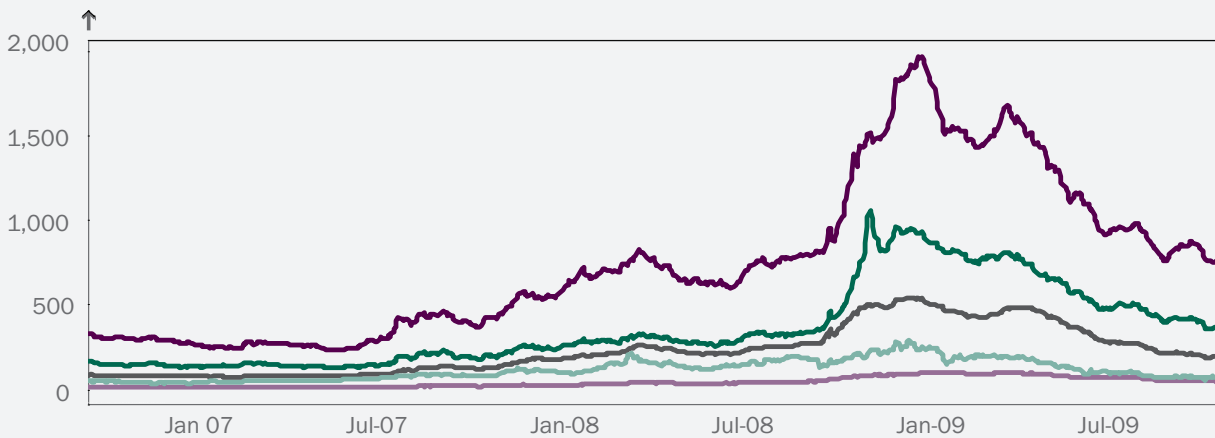
The dollar is fundamentally undervalued within the G3, although the risk environment remains central, (and negative) to short-term performance. 2010 performance will be dominated by U.S. exit policy from QE. **We will leave the allocation unchanged at 13%.**

## Target Allocation — Non-Dollar Denomination

(November 2008 - October 2009)



## Option Adjusted Spread (OAS)



### KEY NAME

- Global Aggregate Ex USD — OAS
- U.S. Credit — OAS
- U.S. Corporate High Yield — OAS
- Global Emerging Markets — OAS
- US Securitized: MBS, ABS & CMBS — OAS

Source: Barclays Capital as of October 15, 2009

Past performance is not indicative of future results.

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