

DoubleLine™

# Monthly Commentary

July 2010



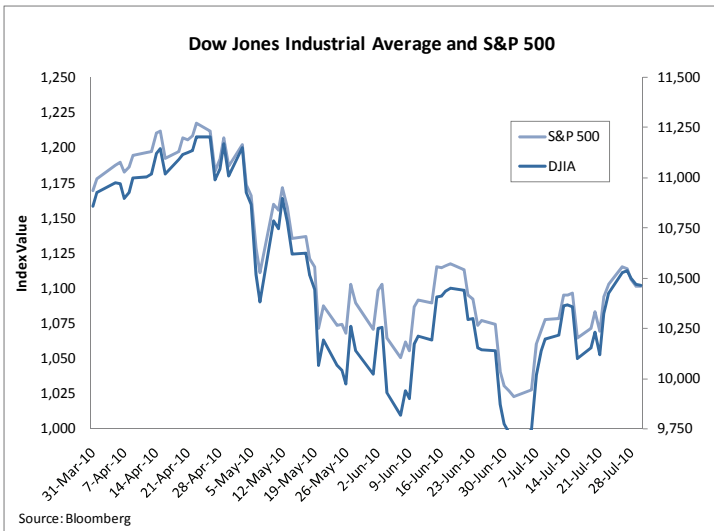
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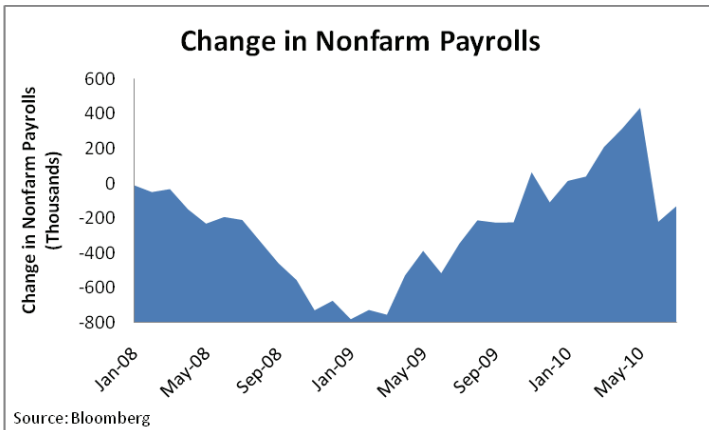


## Overview

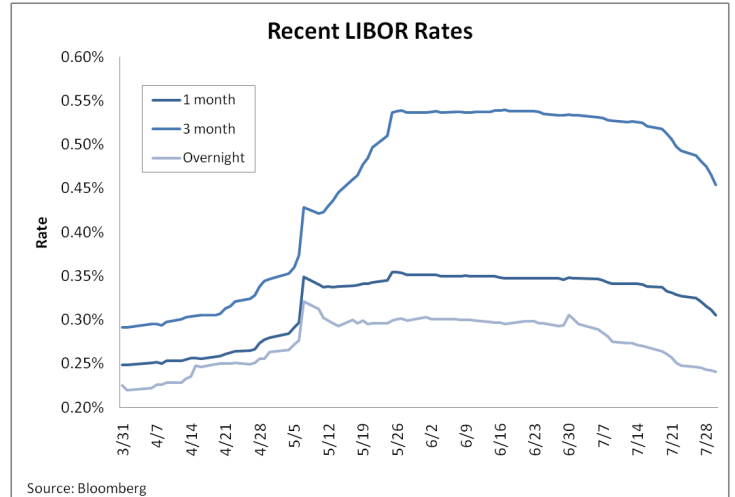
The major domestic equity indices posted large gains in July, with the S&P 500 gaining 7.01%, and the Dow Jones Industrial Average rising 7.23%.



The non-farm payroll report fell once again as 131,000 jobs were lost during the month.

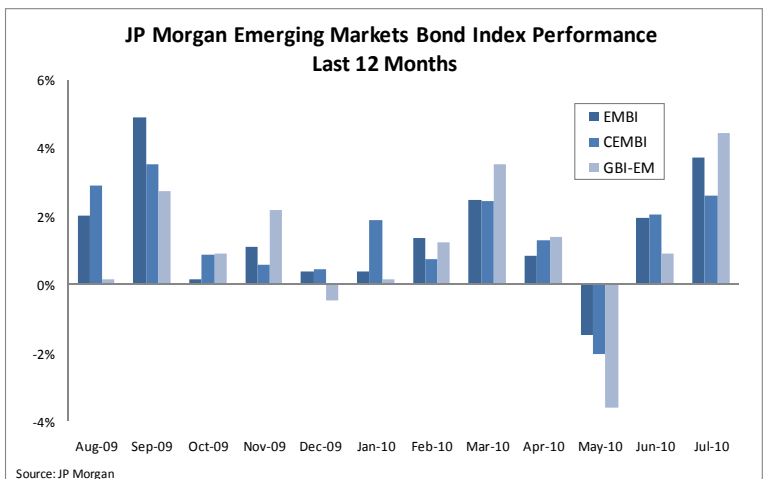


LIBOR rates reversed June's rising trend, as 1-month LIBOR fell 6 bps, closing the month at a yield of 0.31%. The 3-month LIBOR rate fell 8 bps to 0.45%, while overnight rates fell 4 bps to 0.24%.



## Emerging Markets

In July, the non-investment grade credits outperformed their higher-quality investment grade counterparts. The strongest returns were posted by the J.P. Morgan Emerging Market Bond Index Diversified Single BB Sub Index at 5.24%, while the Investment Grade Sub index returned 3.33%. The Corporate Emerging Markets bonds were the worst-performing sector, returning 2.61%. Of the CEMBI regions, Africa and Latin America had the highest performance at 3.34% and 3.27% respectively. Government local currency bonds issued by Emerging Markets were the best-performing sector, returning 4.43%. The GBI-EM's positive returns for the month were primarily driven by bond and currency gains in the Middle East/Africa and Europe.



	Tickers	Quarterly Return	YTD Return	YTM	Spread	S&P Ratings
EMBI	JPGCCOMP	1.24%	5.56%	6.42%	355	BB+
CEMBI	JBCDCOMP	1.26%	6.44%	6.43%	399	BBB
GBI-EM	JGENBDUU	-1.40%	3.45%	6.44%	NA	A-

	Tickers	Monthly Return	YTD Return	YTM	Spread	S&P Ratings
EMBI	JPGCCOMP	4.06%	9.85%	5.94%	310	BB+
CEMBI	JBCDCOMP	2.61%	9.22%	6.08%	371	BBB
GBI-EM	JGENBDUU	4.43%	8.03%	6.28%	NA	A-

The EMBI ended July at a record low yield of 5.94%. The shift in market sentiment toward risk over the last couple of months has been primarily driven by the following factors:

- relatively benign outcome of the European bank stress test and the market’s willingness to accept the results;
- adjustments by peripheral European governments to bring down their budget deficits from low double digits to high single digits;
- better-than-projected results from US and European companies;
- strong inflows into the asset class.

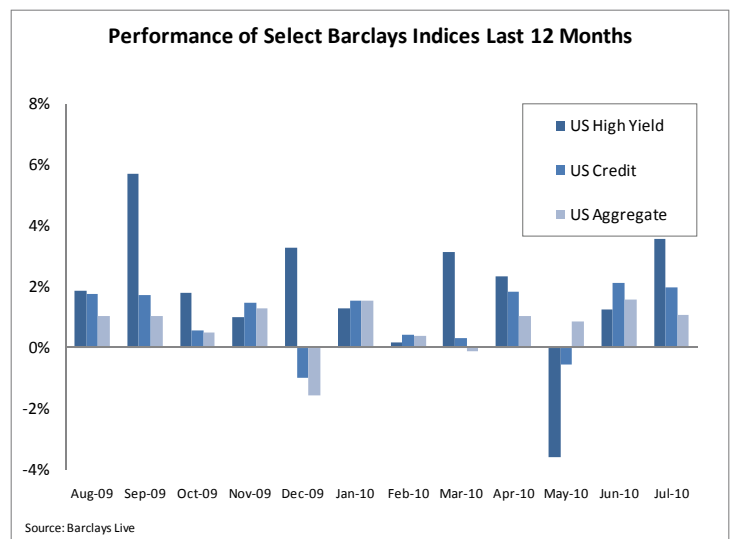
The positive sentiment toward risk and the asset class led to a “chase for yield” during the month and resulted in very strong returns for some of the double and single B rated sovereign credits. These credits are now trading 100-200 bps through comparably rated U.S. credits, which seems over done at this stage.

Given persistent European sovereign and bank debt concerns, the weaker-than-expected U.S. economic numbers and U.S. debt concerns at the federal and state levels, the global backdrop could still pose challenges in the remaining months of 2010.

Our investment strategy continues to focus on high quality investment grade credits. We maintain an underweight position in the Central and Eastern European region and maintain an underweight position to the lower-rated sovereign credits.

## Global Developed Credit

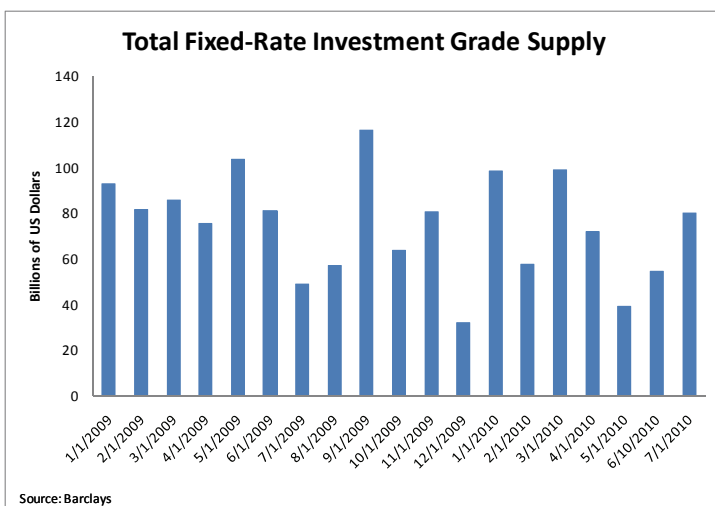
The U.S. credit markets outperformed in July following two months of negative excess return in the Investment Grade and High Yield sectors. The rally was strong enough to move relative performance back into positive territory on a year-to-date basis. The Barclay’s Capital US Credit Index outperformed duration-matched Treasuries by 123 basis points (“bps”) during July, and the Barclay’s High Yield Index posted an excess return of 277 bps during the same period.



Within the investment grade universe, the best-performing sectors included Refining (+307 bps); Independent Energy (+256 bps); Oil Field Services (+248 bps); Tobacco (+239 bps) and Pipelines (+234 bps). The worst-performing sectors were Retailers (-4 bps); Healthcare (+20 bps); Consumer Products (+21 bps); Diversified Manufacturing (+23 bps); and Restaurants (+24

bps). Debt rated in the lower tier of investment grade (Baa-rated) outperformed higher-rated (single-A rated or better) debt. Similarly, speculative-grade bonds surged 3.56%, capping the best performance month since September 2009. All sectors participated in the rally and finished the month in positive territory on both an absolute and duration-neutral basis with financial credits dominating. Life Insurance (+11.25%), Property and Casualty Insurance (+5.62%), Wirelines (+4.80%), Banking (+4.62%) and Wireless (+4.48%) produced the best returns. Supermarkets (+1.13%), Electric (+2.03%), Paper (+2.45%), Airlines (+2.47%) and Food and Beverage (+2.52%) generated positive albeit below-average returns. As was the case with investment grade credits, lower-quality issues (Caa-rated) outperformed their higher-rated counterparts.

Fixed rate investment grade supply for July stood at \$80 billion, which was the third-largest issuance month after March (\$99 billion) and January (\$98 billion). In the High Yield space, new issuance (across multiple currencies) totaled \$20.4 billion, which represents a record for the month of July. Year-to-date issuance in dollar-denominated High Yield debt totaled \$123.6 billion.



Concerns surrounding the strength of consumer demand within the context of the economic recovery continue to dominate the growth outlook. In addition, the recently released second quarter GDP data are raising concerns about the degree to which the inventory cycle can

accelerate in the absence of solid increases in end demand. However, despite recent macro economic data which have cast doubt on the strength of the US recovery, over 78% of the companies in the S&P 500 reported second-quarter earnings which beat analysts' estimates, according to Bloomberg data. In addition, the balance sheet strength of many U.S. corporations is intact due to excess cash and ready access to debt markets. This phenomenon has helped to propel a technical bid for credit which is likely to continue into the second half of the year despite the somber economic outlook and a market which still encompasses a high degree of event risk.

On a global basis, the potential systemic impact of this year's debt crisis in Europe and the accompanying cuts in government spending have put a still tentative global recovery at risk. Yet progress on issues of systemic risk such as those addressed in the recent European stress tests have added to the improved sentiment, as has the finalization of financial services reform regulation in the U.S. However, evidence of a cooling economy in China underscores the global impact of a potential reduction in risk appetite by investors. DoubleLine continues to maintain a conservative posture towards credit.

## Agency Mortgage-Backed Securities

The U.S. Agency mortgage market returned 0.87% for the month of July. This compares with a return for the Barclay's Aggregate U.S. Bond Index of 1.07%. This underperformance of the mortgage sector was due to the shorter duration of the mortgage market as compared to the aggregate market as interest rates fell for Treasury maturities seven years and less. At the end of July, the mortgage market had a duration of 1.7 while the aggregate market had a duration of 4.1. On a duration-adjusted basis, Agency MBS performed as well as could be expected. Spread product did well on the month,

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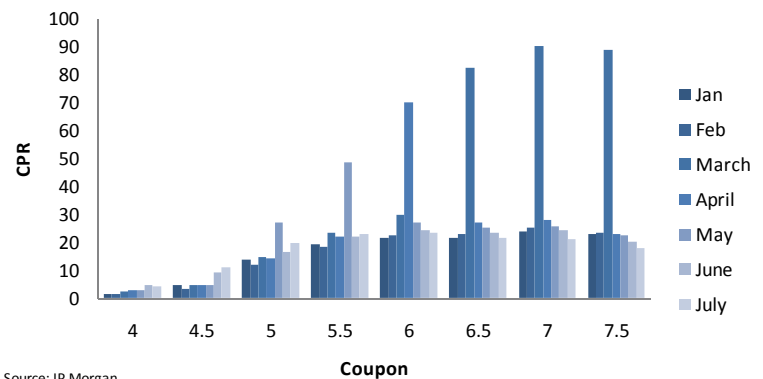


illustrated by a 2.12% return for the investment grade corporate index and tightening of swap spreads. During the month, 2-year swap spreads tightened by 19 basis points; 5-year swap spreads by 9 bps and 10-year swap spreads by 8 bps.

By the end of the July, the average price of the mortgage market was at 106.9. This is an all-time high price and up from the 106.3 level at the end of June. Our thoughts on the Agency sector of the mortgage market remain largely the same. We believe mortgage prices are sustainable at these high levels as long as economic conditions remain unchanged. Given the state of the U.S. housing market, prepayment speeds should stay around the levels experienced over the past few months. At these speeds, the mortgage securities provide ample current yield pickups over Treasury yields. Our biggest concern in evaluating these Agency securities is their high negative convexity; thus their expected price movement should not be favorable in a changing rate environment.

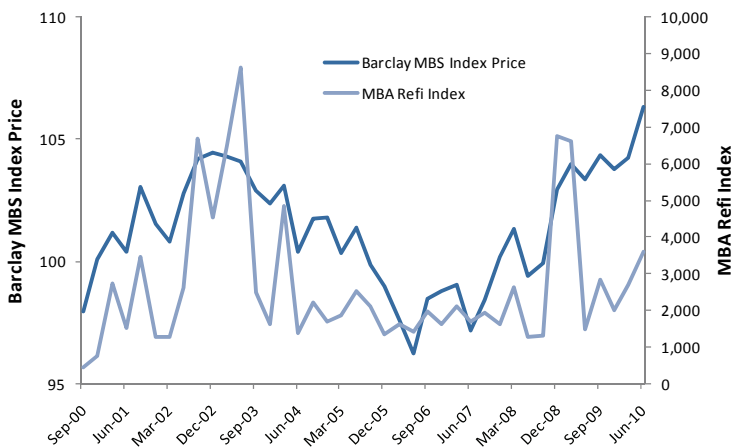
the return and the pricing of these securities. FNMA 6's traded from 109 down to 108-22 over this concern. Most research desks produced their own reports discussing the issues. After the dust settled, the premium securities traded back up to their pre-"refi talk" levels. For further information on the refinancing issue, please see Jeffrey Gundlach's commentary, "Proposed 'Slam-Dunk Stimulus' Program," available at [www.doubleline.com](http://www.doubleline.com).

**Prepayment Speeds of Generic FNMA Passthroughs 2010**



Source: JP Morgan

**Barclay MBS Index Average Price vs. MBA Refi Index**



Source: Barclays Capital and Bloomberg

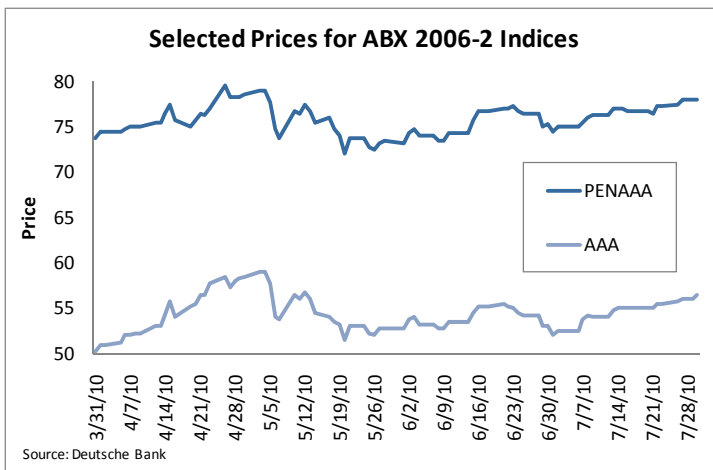
The idea of a U.S. Government "refi" took center stage in July after two Wall Street research desks proposed this idea to help economic conditions. One of the two proponents of the idea has actually been calling for this since 2007, so it should not be considered "new" news. But the fact that these two firms produced their reports in July brought much consternation to premium Agency mortgages as these securities were trading at or near all-time high prices; faster prepayment speeds hurt

As a result of our analysis, we maintain our "hold" evaluation on the U.S. Agency mortgages. When rates change dramatically, we expect mortgages to underperform other indices, but given the state of the economy and the housing market, we do not foresee that happening for awhile.

## Non-Agency Mortgage-Backed Securities

The trends reported in the previous month's commentary continue to be the norm in July. The non-Agency mortgage-backed securities sector made price gains of 0.5% to 2% or higher over the month. The Primex FRM 1 Index, which closed at 107.25 in June, ended at 108.17 by the end of July. The FRM 2 Index posted even larger gains, closing at 101.42 for July, up from 99.25 in June. Whereas a higher-quality Alt-A pool could trade at 8% loss-adjusted in June, we are now seeing alt-a pools slowly moving toward a yield in the 7%-7.5% range. The continuing upward price

movement again depicts a market that is ever searching for yield while the supply continues to shrink through amortization, prepayment and default. In fact, it appears that all fixed income markets are flush with investors and lacking product, even in the corporate credit market. We are still of the opinion that the non-Agency mortgage market continues to offer the highest risk adjusted returns in the fixed income arena.



A number of liquidations this month brought additional supply to a market that also seemed to add new buyers. As sector prices continue to improve, the majority of bonds are now actually trading as opposed to hanging out on bid lists and seeing no buyers. Both delinquencies and prepays in the non-Agency market seem to have stabilized over the recent months, possibly contributing to the increase in both price and demand for the sector during July. Some observers have attributed the aforementioned stabilization to a recent alleviation of price decline in the housing market. Several mortgage analysts agree that the housing market could fall another 5%-8%, indicating that the worst of the falling prices could be over. This does not mean, however, that housing prices will recover anytime soon, but simply the abyss that was housing has been given a plateau or floor. We also caution housing as an asset class is notoriously heterogeneous, varying by location, price tier, transaction type (e.g., foreclosure distressed versus normal sales), transaction finance and other variables. This makes measurement of housing

prices in the aggregate fraught with statistical bias. There is evidence that readings of price gains since 2009 in the major house price indices may owe more to changes in sales mix due to fluctuations in REO and short-sale supply coming to market and seasonal effects than to bona fide price appreciation. We shall continue to monitor housing prices and their effect on the mortgage market in future editions.

Prospective and implemented legislation continues to provide a major source of volatility for the non-Agency market. Last month, we applauded the efforts Fannie Mae to put strategic defaulters under the spotlight. In July, the Federal Housing Finance Agency (FHFA), which is the conservator of both Fannie Mae and Freddie Mac, issued 64 subpoenas to various originators and issuers of non-agency securities bought by both agencies. In an effort to maintain their involvement with the CRE mandates given by Congress over the years, both Agencies were active participants in the subprime and alt-a mortgage markets. The subpoenas seek to determine whether misrepresentations to the Government Sponsored Enterprises (GSEs) regarding the underwriting and quality of the underlying loans might require issuers to repurchase debt. If so, the GSEs could recoup funds from firms that may include Wall Street's largest investment banks. At stake is as much as \$30 billion in repurchases; however, we do not expect this issue to reach an immediate resolution. July also saw the approval of the 2000+ page financial reform bill. We continue to monitor the effects of this legislation as uncertainties over unintended consequences are a source of anxiety for participants in the financial markets. The goal of the financial reform bill was to create a more structured and more transparent market while re-starting both the non-Agency market and the asset-backed securities markets. Updating Regulation AB, which deals with the registration, disclosure and reporting requirements for publicly issued ABS, was a main goal of this legislation. In order to revamp the Regulation AB, the SEC has accepted suggestions and comments from both investors and issuers; however, these two vested

parties typically have diametrically opposing interests and thus diametrically opposing views. For further information regarding the investor's point of view, you may visit the Association for Mortgage Investors website ([www.the-ami.org](http://www.the-ami.org)). The most surprising omission in the financial reform bill would be an absence of a means of addressing the GSEs and their massive amount of debt.

Finally, in early July, a group called Cambridge Place Investment Management, founded by two former Goldman Sachs bankers, filed suit against many of the Wall Street firms involved in the subprime market, claiming more than \$1.2 billion in damages they say were related to untrue statements, faulty underwriting and misleading appraisals and loan applications in securities they purchased. We are monitoring this suit with interest as it could actually form the basis for a class action suit that could bring the entire market to a halt until the case is settled.

To summarize, participants in today's market must contemplate an extraordinarily wide range of outcomes due to policy uncertainties stemming from Washington and the legal system. This requires close vigilance to the evolving environment while we continue to discount securities and structure portfolios to both exploit present inefficiencies and manage for divergent risks. Ultimately, we hope that impending litigation coupled with the regulatory reform will help to bring about a liquid, transparent and functional secondary mortgage market.

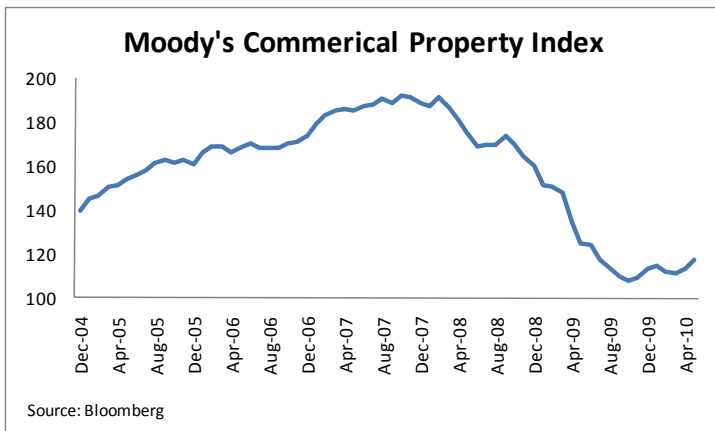
## Commercial Mortgage-Backed and Asset-Backed Securities

With absence of any real improvement in commercial real estate fundamentals and ongoing concerns surrounding the commercial real estate sector, the CMBS market performance continues to decouple from its collateral performance with a slow but positive grind higher across the investment grade capital stack. Amid a general outlook toward a near- to medium-term deflationary stance

coupled with low rates and cash rich corporate balance sheets, investor demand for yield has garnered interest across spread sectors with CMBS not without neglect. For the month of July, the Investment Grade CMBS segment of the Barclays Aggregate Index returned 2.12%, outperforming the ABS segment by 88bp and the broader index by 105bp. Contrary to CMBS price performance during April/May, we have continued to witness a gradual decrease in price volatility over the last two months as we believe the market has somewhat stabilized with much of continued focus for bonds at the top of the capital structure.

From a CMBS collateral performance standpoint, we have yet to see a significant improvement in fundamentals despite various market participants noting signs of stabilization based on the latest delinquency data. Although the rate of delinquency increase has slowed down over the past few months, we would note that a lingering pipeline of loan maturities remain to be taken into consideration as the original five- and seven-year loans from 2006/2007 transactions begin to reach their payment obligation. With that said, 30+day delinquencies for the month of July rose by 12bp to 8.39% while 60+day delinquencies increased by 24bps to 7.39%. In addition, the latest Moody's Commercial Property Price Index (CPPI) posted a 3.6% gain for the month of May and represents a 38.9% decrease in value from October 2007 peak. As noted previously in our June commentary, the Moody's CPPI price gains do not necessarily signal a definitive rebound in commercial real estate prices. All in all, transaction volumes continue to remain at an all-time low, hence we believe the index data may be a bit skewed and should be cautiously viewed.

From an investment standpoint, we remain cautious regarding the CMBS sector despite lower price volatility in the past few months. To date, our investment focus in this sector continues to be heavily weighted at the top of the capital structure with a focus on short-duration assets as we believe this area represents good relative value across



spread sectors. In addition, we have, from time to time, identified pockets of CMBS exhibiting relative value on a “storied” basis where we have the ability to drill down into collateral/borrower level credit/data. In summary, we remain active in this sector albeit with a cautious outlook as CMBS collateral performance and macroeconomic fundamentals remain weak.

## U.S. Government Securities

The furious Treasury rally of the second quarter slowed in July, although many rates crept toward historic lows in August and talk of deflation and a double-dip recession intensified. Expectations of a Fed tightening and a gradual rise in interest rates were abandoned. The prospect of new stimulus measures from the Fed – including a new round of asset purchases – became a frequent topic of conversation of economists. Investors were left reaching for yield; in doing so, they pushed out the yield curve and move out of Treasuries into Agency securities. The two-year Treasury yield fell another 5 basis points in July to close at 0.55%, near its all-time low. The five-year Treasury was the best performing on-the-run, falling 18 bps to 1.60% at month-end. The yield curve flattening did not extend to the longest issues, as the 30-year bond yield rose 10 bps to 3.99%.

## Yield Curve

	6/30/2010	7/31/2010	Change
3 month	0.17	0.14	-0.03
6 month	0.22	0.19	-0.03
1 year	0.31	0.27	-0.03
2 year	0.60	0.55	-0.05
3 year	0.96	0.82	-0.14
5 year	1.77	1.60	-0.18
10 year	2.93	2.91	-0.03
30 year	3.89	3.99	0.10

Source: Bloomberg

The Barclay’s Capital U.S. Government index returned 0.68% in July, lagging other sectors by a significant margin. Treasuries returned the same 0.68%. The two-year note returned 0.16%. The five-year note posted the best return of the bellwether issues at 1.10%. The 10-year note eked out a 0.33% return, while the 30-year bond returned -1.16%. Agencies issues returned 0.66% for the month, which was better than Treasuries by 20 bps after adjusting for the shorter duration of the Agency sector. Deflation fears again weighed on inflation-adjusted Treasuries in July. TIPS returned 0.14%, lagging conventional Treasuries for the third consecutive month.

The government portfolio returned 0.66% in July. The return was boosted by the portfolio yield curve posture. The portfolio was well positioned to benefit from the yield curve flattening in the 2-year to 10-year portion of the curve. The portfolio was not able to capitalize on the sharply tighter spreads in the Agency sector. The portfolio was overweighted in Agency securities by market value but was focused on comparatively short maturities. The July result brings the two-month return on the portfolio to 3.17% versus 2.36% for the Barclays U.S. Government index.

Portfolio strategy was unchanged in July, positioned for a flatter yield curve and stable Agency spreads. Portfolio holdings emphasize 10-year Treasuries as the best opportunity along the yield curve. The portfolio is overweight Agency securities, but is focused specifically on two- to three-year callable issues.

## **Barclays US Aggregate Bond Index**

The Barclays US Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the US investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

## **Barclays US Credit Index**

This index is the US Credit component of the US Government/Credit Index and consists of publically issued US corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered. The US Credit Index is the same as the former US Corporate Investment Grade Index.

## **Barclays US Government Index**

This index is the US Government component of the US Government/Credit Index and includes securities issued by the US Government, including treasuries and agencies. This includes public obligations of the US Treasury with a remaining maturity of one year or more and publically issued debt of US Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the US Government.

## **Barclays US High Yield Index**

This index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issuer from countries designated as emerging markets (e.g. Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeros, step-up coupon structures, 144-As and pay-in-kind (PIK, as of October 1, 2009) are also included.

## **Dow Jones Industrial Average**

The Dow Jones industrial Average is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

## **JP Morgan Corporate Emerging Market Bond Index (CEMBI)**

This index is a market capitalization weighted index consisting of US-denominated Emerging Market corporate bonds. It is a liquid global corporate benchmark representing Asia, Latin America, Europe and the Middle East/Africa.

## **JP Morgan Emerging Markets Bond Global Diversified Index (EMBI)**

This index is uniquely-weighted version of the EMBI Global. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts of debt outstanding. The countries covered in the EMBI Global Diversified are identical to those covered by EMBI Global.

## **JP Morgan Government Bond Emerging Markets (GBI EM)**

This index is the first comprehensive, global local Emerging Markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure.

## **London-Interbank Offered Rate (LIBOR)**

British Bankers Association Fixing for US Dollar. The fixing is conducted each day at 11 am (London time). The rate is an average derived from the quotations provided by the banks determined by the British Bankers' Association.

## **Moody's REAL/Commercial Property Price Index (CPPI)**

This index tracks fluctuations in value by measuring the sale price of specific properties that have been sold at different points in the real estate cycle.

## **PrimeX**

The PrimeX index is a synthetic credit default swap (CDS) index which references non-Agency Prime residential mortgage-backed securities (RMBS). There are 20 prime RMBS deals referenced in each sub-index from 2005, 2006, and 2007.

## **S&P 500**

Standard & Poor's US 500 Index, a capitalized-weighted index of 500 stocks.

An investment cannot be made in an index.

## **Important Information Regarding This Report**

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DoubleLine seeks to maximize investment results consistent with our interpretation of client guidelines and investment mandate. While DoubleLine seeks to maximize returns for our clients consistent with guidelines, DoubleLine cannot guarantee that DoubleLine will outperform a client's specified benchmark. Additionally, the nature of portfolio diversification implies that certain holdings and sectors in a client's portfolio may be rising in price while others are falling; or, that some issues and sectors are outperforming while others are underperforming. Such out or underperformance can be the result of many factors, such as but not limited to duration/interest rate exposure, yield curve exposure, bond sector exposure, or news or rumors specific to a single name.

DoubleLine is an active manager and will adjust the composition of client's portfolios consistent with our investment team's judgment concerning market conditions and any particular security. The construction of DoubleLine portfolios may differ substantially from the construction of any of a variety of bond market indices. As such, a DoubleLine portfolio has the potential to underperform or outperform a bond market index. Since markets can remain inefficiently priced for long periods, DoubleLine's performance is properly assessed over a full multi-year market cycle.

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