DoubleLine®

Monthly Commentary

October 2011

DoubleLine®

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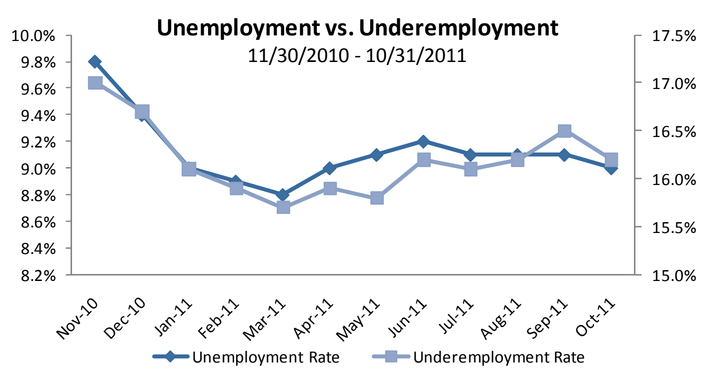
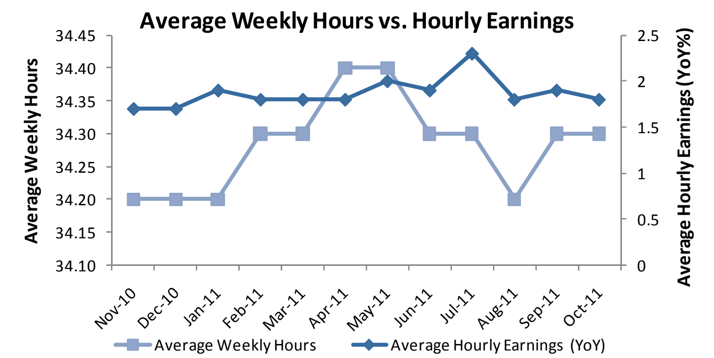
Overview

October experienced an improvement in both the headline Unemployment Rate (U3) and the broader U6 Unemployment Rate (U6). The headline Unemployment Rate fell by 0.1% to 9.0%. This was the result of true job growth in October – not via the result of a decrease in the labor force. U6 Unemployment also fell, to 16.2% from 16.5% in September.



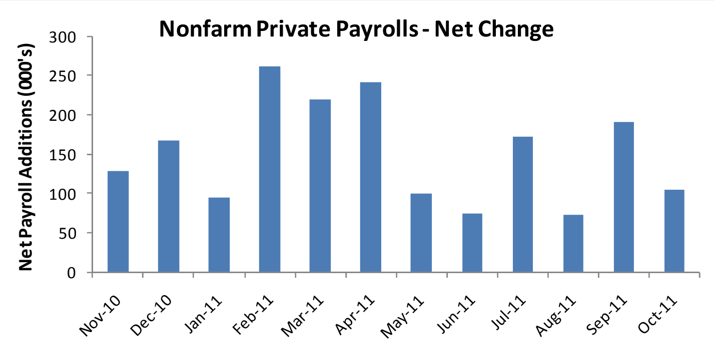
Source: Bureau of Labor Statistics

Average Hourly Earnings in October were 1.8% above where there were for the same period last year, while Average Weekly Hours Worked held steady versus last month at 34.3 hours.



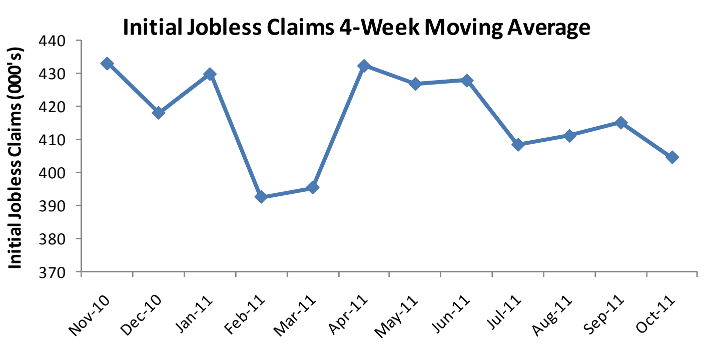
Source: Bureau of Labor Statistics

Nonfarm Private Payrolls grew by 104k in October, growing by a slower amount than the revised amount of 191k in September.



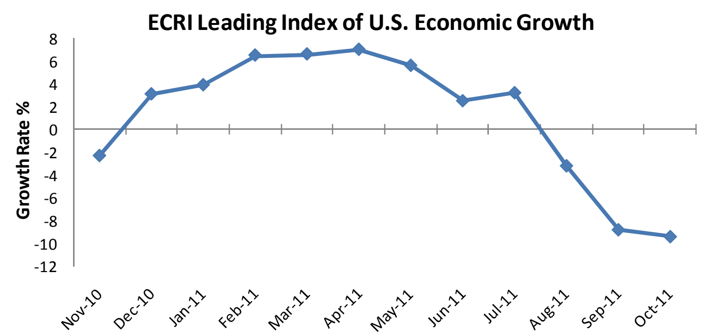
Source: Bureau of Labor Statistics

The four week moving average of Initial Jobless Claims was 405k for October – a smaller amount than the 415k average for the month prior.



Source: Department of Labor

The Economic Cycle Research Institute (ECRI) Leading Index Growth Rate continued to be in solid negative territory coming in at -9.40% for the last week in October.



Source: Economic Cycle Research Institute

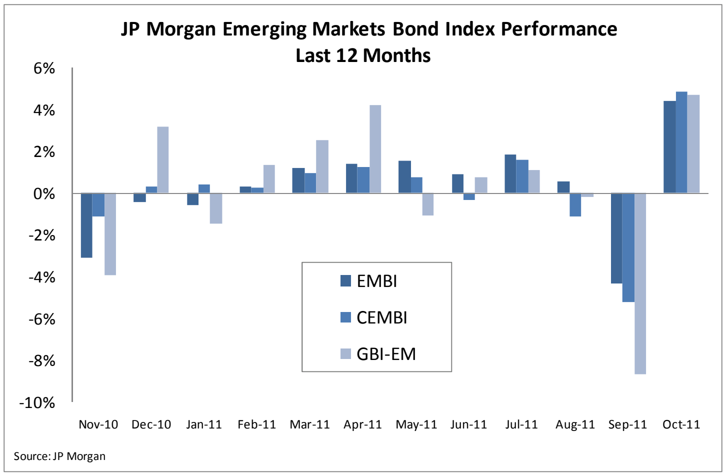
Emerging Markets

In Emerging Markets Fixed Income, the three sectors of the market – the external sovereign, corporate debt and local currency bonds, represented by the JP Morgan Emerging Markets Bond Index Global Diversified (EMBI), the JP Morgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI) and the JP Morgan Government Bond Index Emerging Markets Broad Diversified (GBI-EM), respectively – posted strong positive returns for the month of October.

	Tickers	Monthly Return	Last 3 Months	YTD	YTM	Spread
EMBI	JPGCCOMP	4.40%	0.37%	7.09%	5.74%	370
CEMBI	JBCDCOMP	4.82%	-1.77%	3.03%	6.09%	432
GBI-EM	JGENBDUU	4.71%	-4.56%	2.54%	6.43%	NA

Source: JP Morgan
(Past performance is no guarantee of future results.)

For the month of October, emerging markets (EM) corporate bonds were the best performer, returning 4.82%, followed closely by EM local currency bonds at 4.71% and EM external sovereign bonds returning 4.40%. Much of October was a reversal of September's risk-off mode, with high yield bonds outperforming high grade bonds. EM sovereign high yield bonds returned 5.24% versus 3.81% of its high grade sub index. EM corporate high yield bonds returned 9.27% versus 3.02% of its high grade sub index. Much of September's negative returns were driven by headline news out of Europe. This reversed in October as the market perceived Europe was finally on track to solving some of its issues. Europe was the best performing region for EM external sovereign bonds and EM corporate bonds, returning 4.73% and 7.55%, respectively. For EM local currency bonds, Latin America was the best performing region as strong returns were driven by currency gains from the Brazilian Real, Chilean Peso, and Mexican Peso. The Russian Ruble and Turkish Lira were also strong performers for the month of October.



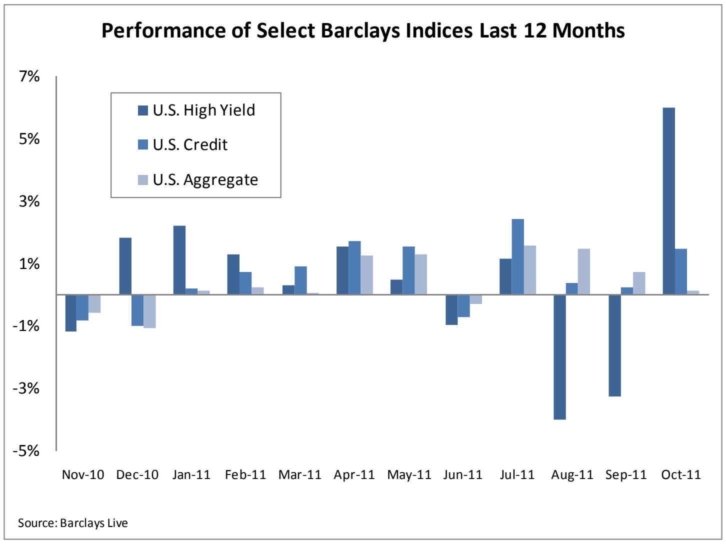
The near-term direction of EM asset performance was once again driven by policy decisions out of Europe. On October 26, eurozone members met in Brussels to announce their "Grand Plan", a package of measures aimed at addressing Europe's debt and banking crisis, with the hope of regaining market confidence. The eurozone announcements appear to have succeeded somewhat as demonstrated by EM spreads tightening by 72 bps by month end. Proposed measures include: an increase in the Greek debt hair-cut from 21% to 50%; an increase in the European Funding Stability Facility (EFSF) bailout fund from €440 million to over €1 trillion; and an increase in capital by the eurozone banks to a mandatory 9% by June 2012.

Despite the good news provided by the European Union (EU), implementation risk still remains given the lack of detail, size and complexity of the "Grand Plan" and the negative sentiment in Southern Europe toward heavy austerity measures. In addition to the austerity packages, the push to recapitalize banks will likely drive GDP growth rates lower over the short- to medium-term as liquidity is removed from these markets. Global economic data continues to point toward further economic slowdown. Global PMI numbers for October were mixed with positive signs coming out of China, Japan, India and the U.S., while European data came in weaker than expected. Even with the slight pickup in GDP seen in the third quarter, Federal Reserve Chairman Bernanke guided for slower growth improvements over the next few quarters, and slightly lower, long-run growth potential.

Until details of the "Grand Plan" are specified and implemented, the European debt and banking crisis will continue to dominate market sentiment into the end of the year. The debate over the U.S. and global growth prospects, Greece, and whether the U.S. and Europe are already in or headed for recession, will remain important for EM growth.

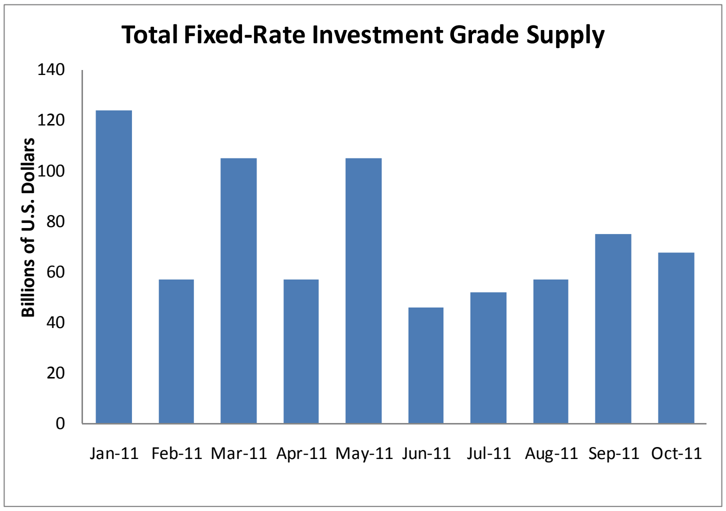
Global Developed Credit

October's improved market sentiment contributed to a rebound in the performance of risk assets, particularly with respect to the high yield market. The Barclays Capital U.S. Credit Index ended October 31 bps tighter, and outperformed duration-matched Treasuries by 238 bps. Year-to-date (YTD) total returns in investment grade credit now stand at 8.10% and YTD excess returns remain negative at -1.26% given the Treasury market's sharp rally this year. The high yield market, as measured by the Barclays Capital High Yield Index, posted the seventh largest monthly return in the past 20 years in October, rebounding from the sell-offs in August and September. The Barclays Capital High Yield Index tightened 140 bps on the month, posting a total return for the month of 5.99%. YTD total returns in high yield now stand at 4.52% and YTD excess return is -1.70%.



Within the investment grade universe the best-performing sectors with respect to excess return included Paper (+584 bps); Media-Cable (+493 bps); Metals (+478 bps); Oil and Gas (+457 bps) and Wirelines (+449 bps). The worst-performing sectors were Broker-Dealers (-27 bps); Building Materials (-17 bps); Lodging (-11 bps); Supranationals (-2 bps) and Packaging (0 bps). All sectors of the high yield market were up in October. The best performers were Home Construction (+12.65%); Gaming (+8.71%); Technology (+8.49%); Construction Machinery (+8.37%) and Media Non-Cable (+8.21%). The worst performing high yield sectors for the month of October were Paper (+1.15%); Refining (+1.33%); Airlines (+1.57%); Pipelines (+2.64%) and Wireless (+3.14%). In both the investment grade and high yield markets, higher beta credit outperformed consistent with the sharp rally across risky assets during the month.

Fixed-rate investment grade supply for October was $67.6 billion, which was largely in line with September. Non-corporates led gross supply this month issuing more than $26 billion of investment grade debt. The high yield market priced $8.1 billion in new issues during the month. There were no fallen angels or defaults in October.



Despite October's strong rebound in credit markets, the sector remains challenged and portfolio positioning in a low growth economy with thin trading liquidity remains difficult. Even though spreads are meaningfully wider on the year, investors are faced with the realities of a corporate bond universe which offers limited sources of significant yield. With many of the macroeconomic questions driving volatility still unanswered, determining what an appropriate liquidity premium for the current market is difficult and the headline risk remains high. Third quarter earnings offered a number of reassuring reports, delivering a brighter outlook for the global economy than the pessimism contained in recent market forecasts; however, the earnings reports also delivered a notable number of misses and outlook downgrades, highlighting the divergence of experiences depending on the sector in question. The real volatility driver continues to reside in Europe: the rapid descent of MF Global into the eighth largest U.S. corporate bankruptcy on the back of outsized exposure to short-term European debt should further serve as a reminder of just how tight the connections are among the world's financial markets.

Mortgage-Backed Securities

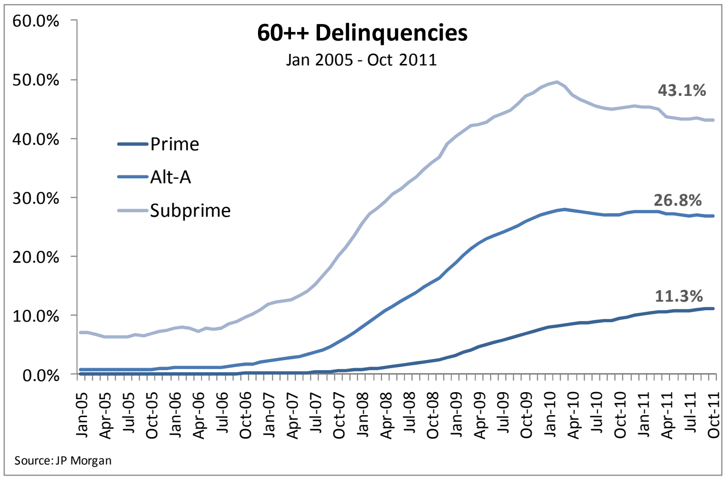
The Bank of America proposed settlement referenced last month continues to be in the news; the update, however, is that the legal venue for contesting the issues has been changed from the New York Supreme Court to Federal Court. This will serve to not only extend the timeline on this settlement, if it occurs at all, but will require more transparency on the settlement. The numerous Attorneys Generals (AGs), including California, New York, and Delaware, are reviewing the settlement and have stated that it should not go through without further investigation.

On October 24, the Federal Housing Finance Agency (FHFA) announced changes to the Home Affordable Refinance Program (HARP): the 125% loan-to-value (LTV) cap would be eliminated; instead of having to be current on your mortgage payments for the last 12 months, borrowers just have to be current for the last 6 months and not more than 1 month late in the previous 6 months; the program was extended to 2013; and perhaps most importantly, the representations and warranties (more commonly known as reps and warrants) mandated under the new program were reduced. Previously, the lender had to warrant that the homeowner met the current payment stipulation, use an automated value method (AVM) to evaluate the home, and verify the borrower was actually employed. If there was a problem with the loan after the refinance had occurred, the mortgage originator would only be responsible for the representations mentioned. A reduction of this process should increase the volume of refinancing in the Agency market. We estimate that raising the LTV cap adds another 750k loans to the potential mix as well. Overall the total number of loans for potential refinancing appears to be approximately 3-4 million. Such refinance activity would likely be stretched out over the next 1-2 years.

This program would open the way to further dialogue with the banks on their own portfolios. The market perceived a “big refi” program that would get announced last month only to get HARP 2.0. The U.S. government still needs to appear to be helping the housing market in other areas. One of these could be a “HARP-like” program with larger banks on their portfolios, in exchange for some relief on either the robo-signing problem or the reps and warrants issue. These discussions with the AGs are going on quietly and may be reported as early as next month.

Not to be outdone by the AGs or the FHFA, Rep. Scott Garret (R-NJ) announced on October 27 his new proposal for reforming the secondary market in mortgages. The bill included the following: Facilitate Continued Standardization and Uniformity of Mortgage Securitization; Ensure Rule of Law and Legal Certainty; and Provide Additional Transparency and Disclosure. While many appreciate Rep. Garret’s efforts, this bill will be subject to much iteration before coming to fruition, or more importantly a vote in Congress. The next battle in Washington may end up being the loan limits for Freddie Mac and Fannie Mae, which were supposed to be rolled back but got extended in recent U.S. Senate legislation.

For the past few months there has been some pricing pressure within the non-Agency space. Looking at the fundamentals of the underlying loans, one would not notice much change in the performance of the loans during this period. Delinquencies on certain classes of non-Agency collateral are actually down. Loss severities have increased slightly over the same period, though nothing monumental with regard to changes in reported numbers. We believe there are two separate situations that exist in the marketplace that have contributed to this weakness: the BASEL III Accord, which will make banks less willing to own



credit assets as there are capital adequacy consequences; and the Volcker Rule within the Dodd-Frank Bill, which while in its infancy stage, would force investment banks and commercial banks to disband their proprietary desks and limit their ability to hold large positions in credit assets. These institutions currently have large positions in this asset class and could be forced to lower their holdings. As a result of these facts, it is believed that dealer inventory positions are down approximately 50% from where they were a few months ago.

Non-Agency Mortgage-Backed Securities

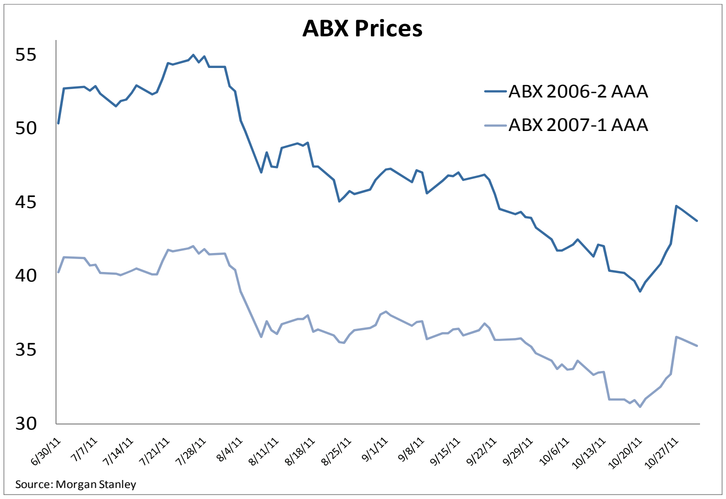
In the non-Agency space, the volume in bids wanted as well as liquidations in total actually decreased in October. Price action within the market seemed to decrease volume.

Current Face Traded	September 2011	October 2011
Total	14,517,135,343	10,314,158,023
Liquidation	4,382,764,408	1,803,088,666
BWIC	10,134,370,935	8,511,069,357

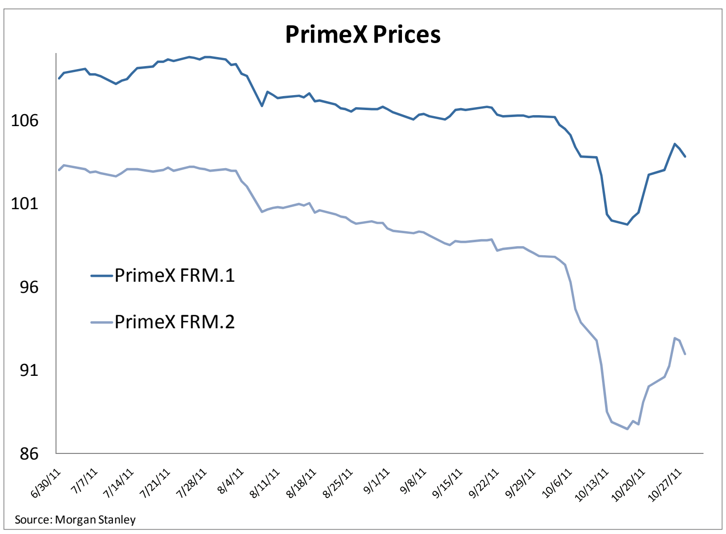
Source: Deutsche Bank; Bid Wanted In Competition (BWIC)

Prices were up month-over-month (MoM) with high volatility during the period. The ABX 97-1 AAA Index closed September 30 at 34.77 and closed October 31 at 35.25. The ABX 06-2 AAA Index closed September

30 at 43.29 and closed October 31 at 43.75.



PrimeX Fixed-Rate Mortgage (FRM) 1 Index went from 102.6 to 103.82, while the PrimeX FRM 2 Index went from 93.05 down to 91.96 MoM (from September to October) – a small month-end boost.



The market technicals remain the same as higher credit quality paper is snapped up promptly while subprime languishes.

Agency Mortgage-Backed Securities

For the month of October, the Agency U.S. MBS component of the Barclays Capital U.S. Aggregate Bond Index had a return of 0.0%. Most of the differences in returns within the sector were due to the Home Affordable Refinance Program (HARP) 2.0 announcement and that the U.S. Treasury yield curve steepened with shorter rates staying flat and longer rates going up. In October, the Ginnie Mae (GNMA) subsector returned 0.25%, while the Fannie Mae (FNMA) and Freddie Mac (FHLMC) subsectors returned -0.10% and -0.08%. The reason for the GNMA sector outperformance was due to growing investor concern about faster prepayments on FNMA and FHLMC securities due to the HARP 2.0 program. Within each of the three subsectors, higher coupon mortgages outperformed lower coupon mortgages. This was attributable to the fact that shorter Treasury rates stayed stable while longer term rates rose. The higher coupon mortgages are generally priced off shorter points along the Treasury curve, while lower coupon mortgages are priced off longer points along the curve.

Conditional Prepayment Rates (CPR)

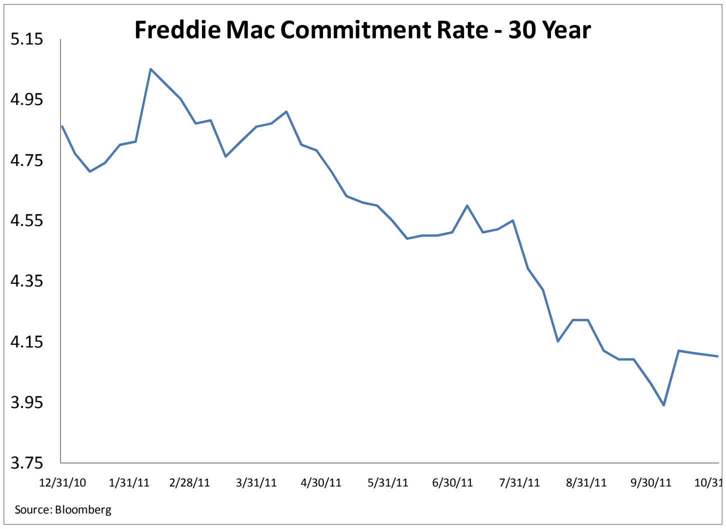
2011	January	February	March	April	May	June	July	August	September
FNMA	19.4	15.2	15.2	13.2	12.8	15.0	15.2	17.3	22.6
FHLMC	21.0	17.4	14.4	12.9	12.2	14.2	14.9	17.0	22.3
GNMA	13.4	12.0	10.2	9.1	8.4	9.6	9.6	11.5	13.9

Mortgage Index	9/30/2011	10/31/2011	Change
Average Dollar Price	107.58	107.30	-0.28
Duration	3.01	3.42	0.41

Index Returns	Aug 2011	Sep 2011	Oct 2011
Aggregate	1.46%	0.73%	0.11%
MBS	1.25%	0.17%	0.00%
Corporate	0.07%	0.26%	1.46%
Treasury	2.78%	1.75%	-0.82%

Source: eMBS, Barclays Capital

The FHLMC Commitment Rate has declined by over 100 bps from early January. As represented by Conditional Prepayment Rates (CPRs), prepayment speeds have picked up for the last 5 months which should come as no surprise given the drop in rates. A closer analysis will show that speeds are still lower than they were last December when rates were 100 bps higher. We believe this reflects the inability of many borrowers to refinance due to tighter underwriting standards and the need for borrowers to come up with more cash to refinance their mortgages.

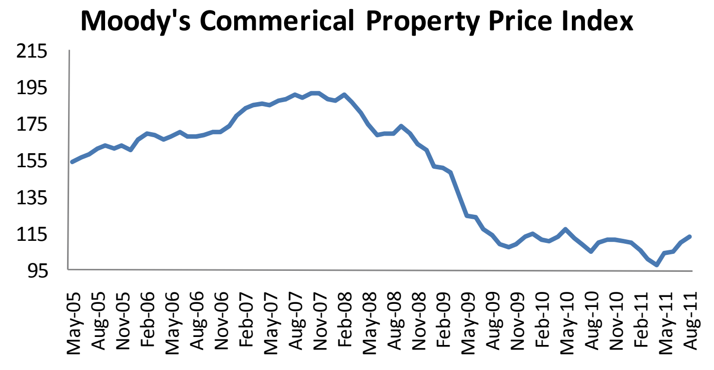


We believe that HARP 2.0 will cause certain agency coupons to increase by 5-10 CPR per year over the next couple of years. These increases are more likely to come in the higher coupons as the change in rules will allow some borrowers that were previously ineligible to prepay into HARP. We also feel that there is a real risk of future depreciation in home prices on a nationwide basis. The weaker the housing market is, the more likely the mortgage market is to gain government intervention, and such intervention could increase prepayment risk to securities, particularly for higher coupons.

Commercial Mortgage-Backed Securities

After spending most of October treading in sync with weaker, broader markets, CMBS ended the month with a strong rally following news of potential Greece bailout by the EU. As such, risk appetite increased across the capital structure even down in junior AAA CMBS (AJs) as a third party hedge-fund decided to put a long list of names on the market given the recent lack of support from the broker/dealer community. Generic last cash flow (LCF) super seniors rallied as much as 3-4 pts, with mezzanine AAA super senior CMBS (AMs) around 5-6 pts on the week. For the month, the CMBS component of the Barclays Capital U.S. Aggregate Bond Index posted a 1.43% return with excess return of 144 bps. Much of the trading activity in the sector remains at the top of the capital structure as generic LCF super senior bonds continue to remain liquid, due to solid two-way flows from the 30% credit support.

On the commercial real estate (CRE) fundamental side, we have yet to see any meaningful improvement in delinquency rates; however, we have observed the pace of deterioration continuing to slow. For the month, 30-day plus delinquency rate dropped 3 bps in September to 9.91%. On the commercial property valuation side, the latest Moody's Commercial Property Price Index (CPPI) showed an improvement reflecting a 2.5% increase in August. We believe this data point may be a bit skewed, however, any large transaction may cause a significant change in the Index, whether positive or negative, since transaction volume continues to remain low.



Source: Bloomberg

We continue to focus on security selection and shorter duration assets, including securities with a more "storied" basis, as our ability to drill down to collateral/borrower level allows us to adequately assess risk. We continue to remain cautious in the sector, despite a slight improvement in the lending environment as the majority of loans that are able to obtain financing in new vintage CMBS are predominantly higher in quality off seasoned transactions.

U.S. Government Securities

The Treasury market took on two distinct characteristics in October, with maturity being the primary distinction with yields inside five years being quiet. The Federal Reserve's "operation twist" – referring to the sale of shorter issues from the Fed's portfolio and the purchase of long maturity securities – caused only a modest, short-lived rise in two- and three-year yields. Yields on longer maturity issues, by contrast, showed a sharp increase in volatility. The month included three sessions with the price of the 30-year bond moving over four points. The sovereign debt crisis in Europe was once again the driving force behind much of the market activity. At month-end, market participants took an optimistic view of developments in the eurozone and moved from the perceived safety of long Treasuries to a host of risk assets, most notably U.S. equities and high-yield bonds in addition to eurozone debt. On October 31, the two-year yield was unchanged and the five-year yield was up just one basis point, while the seven-year yield was higher by 12 bps, the ten-year yield was higher by 20 basis points and the long bond yield was up by 22 bps.

Yield Curve

	9/30/2011	10/31/2011	October Change
3 month	0.02	-0.02	-0.04
6 month	0.05	0.04	-0.01
1 year	0.10	0.11	0.01
2 year	0.24	0.24	0.00
3 year	0.40	0.38	-0.02
5 year	0.95	0.96	0.01
10 year	1.92	2.11	0.19
30 year	2.91	3.13	0.22

Source: Bloomberg

The Barclays Capital U.S. Government Index returned -0.73% in October. Negative returns were concentrated in the long end, with the 30-year bond returning -4.87% for the month, while the 10-year note returned -1.97%. In sharp contrast, the return on the 5-year note was +0.02%. The two- and five-year notes returned 1 bps and 2 bps, respectively. Agency debt slightly outperformed same-duration Treasuries. Inflation-indexed Treasuries had a stellar month, with the Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index returning 1.86%. Municipal debt sold off in October but less severely than Treasuries. The Barclays Capital Municipal Bond Index returned -0.37% for the month of October.

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