

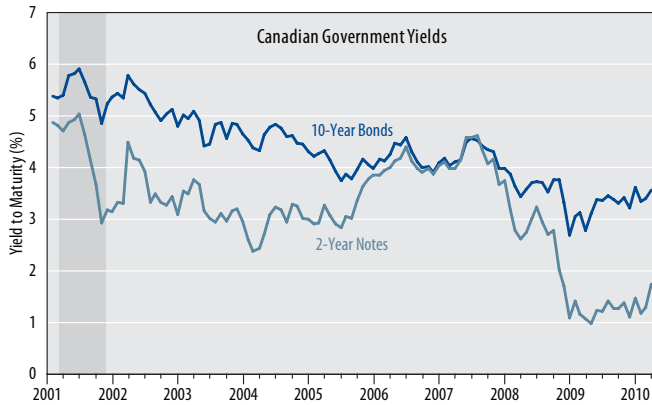
Western Asset Management Quarterly Investment Report

Q1 10

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Interest Rate Trends

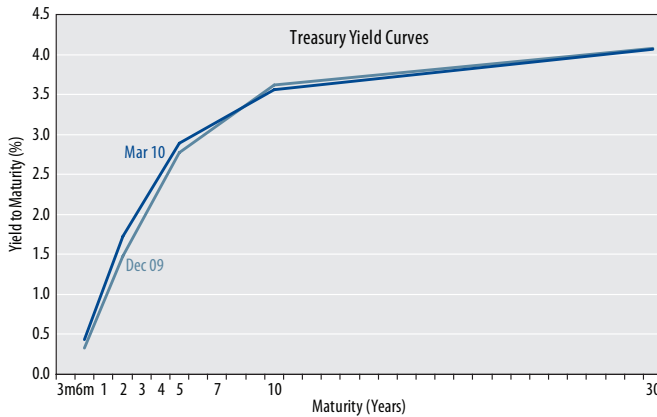
The yield curve flattened as short-term rates rose in anticipation of expected BoC rate hikes in 3Q10; intermediate- and long-term yields decreased slightly. Short-term rates were still much lower than pre-crisis levels.



Source: Bloomberg

Yield Curve Slope

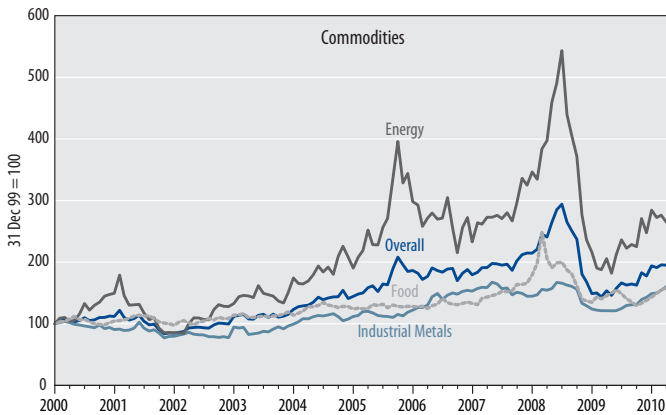
Overall, the yield curve shift was positive. Thirty-year rates dipped 1 bp while two-year yields rose 26 bps. The spread between two- and 10-year yields decreased 30 bps.



Sources: Bloomberg

Commodity Prices

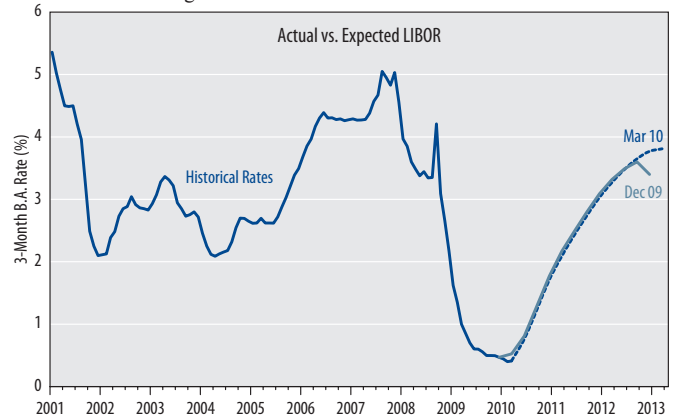
Food prices increased by 10.3% over the quarter. Energy prices decreased and ended the quarter down 6.9%. Overall, the commodity index rose by roughly 0.6%.



Sources: Bloomberg, Bank of Canada

Bank of Canada Update

The BoC maintained its conditional commitment to hold key policy rates at 25 bps. The BoC was focused on its inflation target and the eventual unwinding of its support of financial markets. Headline inflation continued to move toward target.



Source: Bloomberg, MSE

Currency

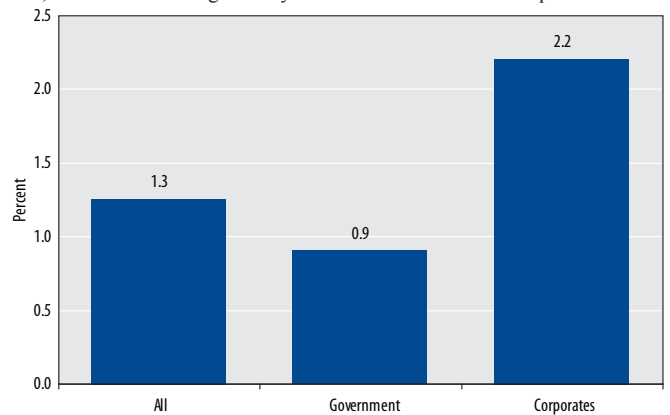
The loonie strengthened against the US dollar for the fourth consecutive quarter, making a run at parity as the Canadian economic recovery was becoming entrenched.



Sources: Bloomberg

Sector Returns

The DEX universe rose 1.26% for the quarter. Government bond returns were positive and specific issues drove corporate performance. The resale housing market remained strong, especially in Ontario and British Columbia, and manufacturing activity climbed each month of the quarter.



Source: DEX Universe, Western Asset

PERFORMANCE SCORECARD

We thought that ...	Therefore, we ...	And the results ...
Government yields were generally likely to remain low over the period.	Maintained a neutral duration position.	+/- Duration performance was flat for the quarter; yields fell in January but rebounded in February and March.
Both short- and long-term government yields were low compared to historic levels, with short-term yield likely to rise.	Maintained an underweight to the short-term and an overweight to the intermediate area of the government curve versus the benchmark.	+ Short-term rates rose while intermediate- to long-term rates were relatively flat, contributing to overall performance.
Provincials offered sound carry and better risk-adjusted returns than governments.	Continued to hold a modest overweight but looked to trim our position.	+ Provincial spreads tightened over the quarter.
Corporate bonds still offered more room for spread compression.	Maintained a corporate sector overweight, particularly in financials.	+ Corporate sectors experienced continued spread tightening and outperformed governments.
Asset-backed securities offered compelling value as the housing market strengthened, and the forecast for 2010 was much higher than that seen in 2009.	Maintained an overweight position in the asset-backed sector.	+ Asset-backed sector spreads narrowed as the resale housing market continued to improve, credit conditions remained favorable and homebuyers were motivated to avoid the implementation of the harmonized sales tax (HST).

OUTLOOK

The Canadian economy is growing again. It has grown at a more than 6.0% annualized rate over the last five months, outpacing the Bank of Canada (BoC)'s growth predictions. Recent economic data has been trending positive as the monetary and fiscal stimulus programs had their intended effect. GDP growth is now expected to come in at 5.5% for the first quarter, up from the 4.7% rate previously expected. Positive corporate earnings, increased manufacturing activity and decreasing unemployment have supported Canada's economic recovery. Both employment and output have already recouped half of their recession losses, and the unemployment rate is expected to continue to fall throughout the year. Taking a run at parity, the Canadian dollar continues to strengthen against the US dollar, but the BoC is not expected to take any specific actions unless currency strength impedes recovery. The Canadian recovery is showing surprising strength and expanding beyond housing and consumer spending; as mentioned, manufacturing for March was up for a fifth consecutive month.

The BoC has repeatedly affirmed its conditional commitment to maintain its current accommodative policy stance until mid 2010, keeping its target for the overnight rate at the effective lower bound of 0.25%. The yield curve is expected to flatten and short-term interest rates are expected to trend higher in front of the BoC's decision. The BoC has stated that its focus is to maintain a 2% inflation target, and it expects inflation to return to this target in the second half of 2011. Headline inflation was positive during the quarter as commodity prices rose, with the exception of energy. As the Canadian economic recovery continues to evolve, policy-makers must act to withdraw fiscal aid in a manner that will not harm the financial markets or business practices needed to maintain economic growth.

The resale housing market remains strong, but has edged slightly lower than its peak from 4Q09. The number on new resale listings that came to market was greater than any other first-quarter period on record, providing buyers with more choice. Unemployment has been above 8.0%

(Continued on next page)

OUTLOOK *(Continued from previous page)*

for fourteen consecutive months but has continued to fall, and ended the quarter at 8.2%.

Credit markets are likely to outperform government bonds throughout the quarter as corporate and economic news has been generally positive. While the magnitude of spread compression in corporates has slowed, spreads in certain sectors are higher than pre-crisis averages. Many of the recent positive corporate earnings were related to successful cost-cutting measures and margin improvement. Investors are still looking for substantial earnings based on production and performance.

Turning to strategy, we remain positive on spread sectors at current yields and are slowly trimming our provincial

sector overweight. Their current yields, while lower than a few months ago, should provide attractive compensation relative to government bonds. We favor credit, particularly opportunities within the financial sector, as we believe the market continues to discount specific issues too severely. However, we do recognize that certain issuers are close to reaching their fundamental values after a strong year of recovery. We expect corporate spreads to have a harder time narrowing, even with a stronger economic environment, if the BoC raises rates early in 3Q10. We are already positioning for this by maintaining a neutral duration position, and by being overweight to longer bonds relative to shorter bonds in order to benefit from yield curve flattening. We are currently maintaining our asset-backed exposure.

INVESTMENT THEMES AND STRATEGIES**Themes**

Economic growth has picked up and the recovery has become entrenched. The BoC will likely maintain its historically low rates until the beginning of 3Q10.

The yield curve remains steep. Credit conditions have improved and short dated government yields may continue to rise as the financial markets begin to price future policy tightening.

Provincials offer sound carry and attractive risk-adjusted returns.

Corporate bond spreads are much closer to the historic averages seen before the financial crisis. Many corporates reported positive news in the prior quarter.

Asset-backed securities appear to offer value as income.

Strategies

Continue to target a tactical neutral duration exposure with the view that overall interest rates will likely increase.

Underweight the short end of the curve while emphasizing the 10-year region versus the benchmark.

Maintain an overweight to this sector but slowly reduce exposure.

Maintain an overweight to the corporate sector, especially in the finance area. However, we plan to trim exposure to select names.

Maintain exposure to these securities and allow them to roll down the curve. The favorable credit conditions and a robust housing market should help these securities.

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