

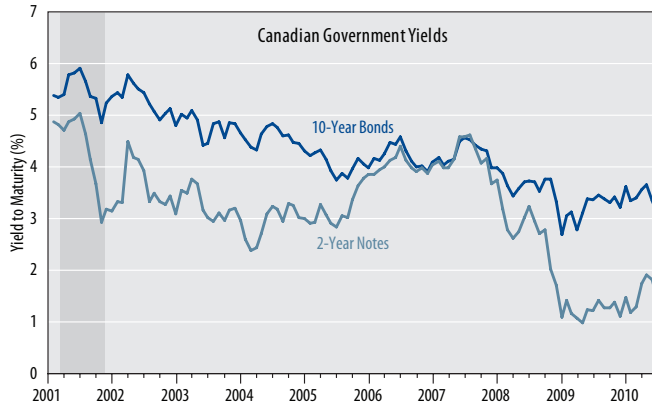
Western Asset Management Quarterly Investment Report

Q210

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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. Short-term rates were still much lower than pre-crisis levels.



Source: Bloomberg

Bank of Canada Update

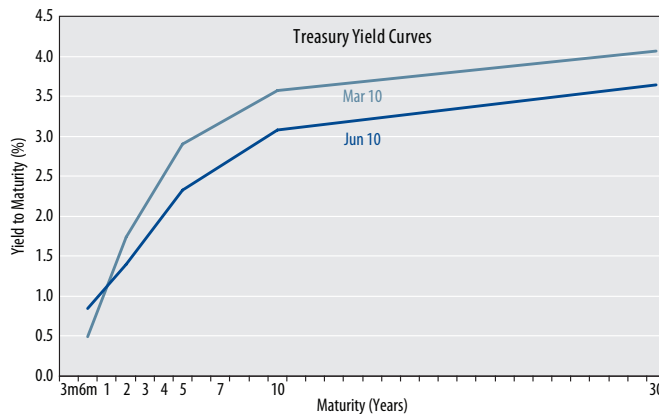
The BoC raised the target for the overnight rate to 50 bps. This decision left considerable monetary stimulus in place while also supporting the BoC's 2% inflation target. Headline inflation continued to move toward target.



Source: Bloomberg, MSE

Yield Curve Slope

Overall, the yield curve shift was negative. Thirty-year rates fell 42 bps while two-year yields fell 34 bps. The spread between two- and 10-year yields decreased 30 bps.



Source: Bloomberg

Currency

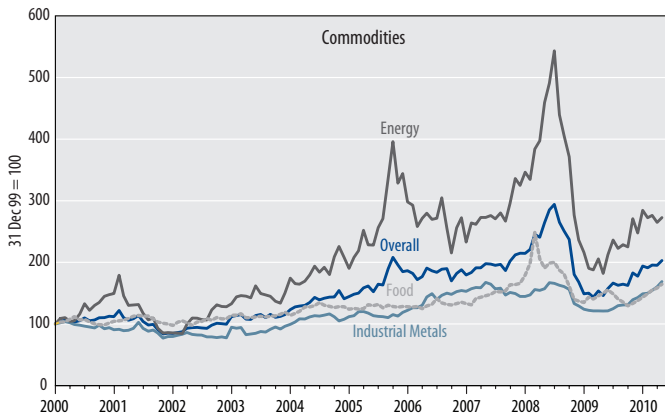
The Canadian dollar weakened against the US dollar over the quarter, as economic indicators were a mixed bag.



Source: Bloomberg

Commodity Prices

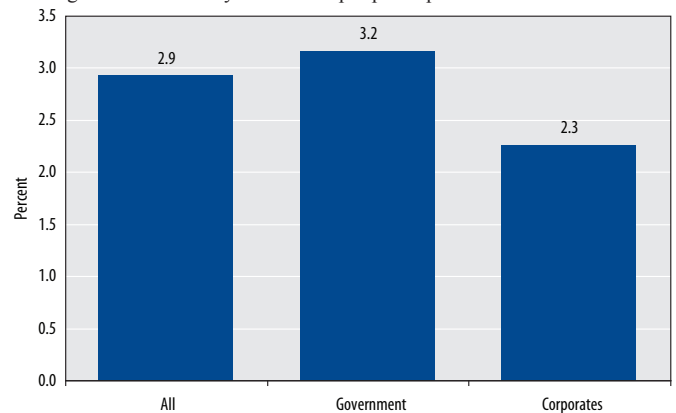
The commodity index fell by 1.51%. Energy prices increased slightly and ended the quarter up 0.09%. Metals and minerals suffered the worst, falling 7.75% for the quarter.



Source: Bloomberg, Bank of Canada

Sector Returns

The DEX universe rose 2.93%. Government bond returns were positive and driven by a flight-to-quality, and corporates lagged. The previously robust resale housing market weakened, especially in Toronto. Manufacturing sales rose in May after a sharp dip in April.



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.	Moved to a modestly short duration position.	– Duration performance was negative for the quarter; yields rose in April but fell in May and June.
Both short- and long-term government yields were low compared to historic levels, with short-term yields likely to rise.	Maintained an underweight to the short-term and an overweight to the intermediate area of the government curve versus the benchmark.	– Rates under a year rose, while intermediate- to long-term rates dropped roughly half a percent, detracting from overall performance.
Provincials offered sound carry and better risk-adjusted returns than governments.	Continued to hold a modest overweight to provincials.	– Provincial spreads widened greatly in May but came in slightly toward the end of the quarter.
Bonds still offered more room for spread compression as corporations tend to strengthen their balance sheets coming out of recession.	Maintained a corporate sector overweight, particularly in financials.	– Corporate spreads widened greatly in May but came in slightly toward the end of the quarter.
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 blew out in April as risk concerns seized the market. When risks subsided, spreads retracted but remained wide as the resale housing market cooled down.

OUTLOOK

An uneven global economic recovery is underway, with countries facing unique challenges. Emerging markets have grown vigorously while most advanced economies have experienced subdued growth dependent on government stimulus policies. The Canadian economy began to cool in 2Q10 following two quarters of strong growth. GDP grew at a 5.6% annualized rate in 1Q10, outpacing Bank of Canada (BoC) projections, but fell flat early in the second quarter. BoC projections currently call for GDP growth of 3.7% for 2010, followed by growth that trends lower over the following two years. The Canadian recovery is no longer being buoyed by a robust housing market, and is expected to grow at a slow pace in the second half of the year. Recent economic data has stalled but unemployment is improving: unemployment fell 0.30% to end the quarter at 7.9%, and the unemployment rate is expected to continue falling through the year. Manufacturing has also remained strong, and has increased eight times in the last nine months. The Canadian dollar weakened in 2Q10 for the first time since the recovery began. Given a somewhat slower US economy, commodity export reliant countries such as Canada became less attractive.

In light of a strengthening economy and functioning financial markets, the need for extraordinary monetary stimulus appears to have passed. On June 1 the BoC raised its target overnight rate by 25 bps to 0.5%. Additional monetary stimulus withdrawals will depend on the economic outlook and the BoC's ability to reach its stated inflation target of 2.0%. Many analysts are predicting another 25 bp rate hike at the BoC's July meeting. The yield curve is expected to flatten and short-term rates are expected to trend higher in front of the BoC's decision. Headline inflation dipped during the quarter as commodity prices fell, with the exception of energy. As Canadian economic recovery continues, policy-makers must keep a mindful eye on the downside economic risks of withdrawing monetary aid, to avoid impacting the financial markets and business practices needed to maintain growth.

After a breakout first quarter, the resale housing market hit the brakes beginning in May. Newly tightened mortgage regulations, the implementation of the harmonized sales tax and anticipated interest rate hikes slowed activity in the second quarter. Sales declined 13.3% from the near-record

(Continued on next page)

OUTLOOK *(Continued from previous page)*

levels seen in 1Q10. Home affordability and home sales activity are expected to slide further as additional rate hikes are anticipated.

We still believe credit markets are likely to outperform government bonds in the coming months as corporate and economic news has been generally positive, though weaker. Provincials and corporates displayed some volatility as spreads have widened and growth has slowed, but economic growth has generally been positive. Many corporate earnings announced in the second quarter were positive as sales increased and the successful cost-cutting measures enacted by many firms greatly improved their profit margins. Investors remain cautiously optimistic about markets despite wariness about the global economy and sovereign risk concerns.

Turning to strategy, we remain positive on spread sectors at current yields and are slowly trimming our provincial sector overweight. Current yields 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, especially after the substantial widening seen during the second quarter. We have a slightly less than neutral duration position and an underweight exposure to the two- to five-year part of the curve, given our expectation of continued BoC policy action. We are currently maintaining our asset-backed exposure.

INVESTMENT THEMES AND STRATEGIES**Themes**

Economic recovery is continuing but at a slower pace than during the first quarter. The BoC will likely raise its current historically low rates in 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 have widened but are still fairly close 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. Favorable credit conditions should help asset-backed securities despite a cooling housing market.

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