



Market Commentary

By Invesco Worldwide Fixed Income



1 Source: Bloomberg

2 Source: Bloomberg

3 Source: Marcus & Millichap Research Services

4 Source: Barclays Capital; fixed-rate securitized loan universe, excludes loans benefiting from defeasance. (Defeased loans are those where collateral has been substituted, typically by a borrower using proceeds from a refinance or sale to purchase a portfolio of U.S. government or agency securities that is sufficient to make all of the remaining debt service payments required by the note. The securities are pledged to the lender, and the lender releases the real estate from the lien of the mortgage. The note typically remains outstanding but is assigned by the borrower to an unaffiliated successor borrower, who makes the ongoing debt service payments.)

All data is as of September 30, 2009, unless otherwise stated. Source: Invesco Worldwide Fixed Income, unless otherwise stated. **This document is for Institutional Investor use only in the US. Circulation, disclosure, or dissemination of all or any part of this material to any unauthorized persons is prohibited without prior written consent of Invesco.**

Mortgage Market Update

Market Commentary

Over the past few months, we have seen very strong rallies in both Treasuries and in risk assets. Since early June, Treasury yields have dropped dramatically, with the 2-year yield 0.44% lower and the 5-year yield 0.54% lower. In risk assets, commercial mortgage-backed securities (CMBS) have rallied nearly 6%, during which time the S&P 500 has also rallied by 14%.¹ Meanwhile, other risk-based assets such as high-yield corporate bonds, high-yield municipals and bank loans have rallied as well. While this price action is a direct result of the tremendous flood of cash that has been injected into the system, it also reflects the fact that there are extremely divergent views on the future direction of the economy. One camp (the Treasury buyers) is betting that the recovery is further away than consensus, while the other group (those buying credit/equities) is betting that the recovery is at hand.

Commercial Mortgage Market Commentary

Despite marginal improvements in consumer confidence, corporate profits and retail sales, commercial real estate continues to face the challenge of rising vacancies, higher unemployment and limited access to financing. U.S. retailers' after-tax profits rose 7% in the second quarter in comparison to the same quarter last year, and declines in corporate earnings are beginning to moderate.² We believe these are certainly steps in the right direction; however, we expect retail store closures and corporate downsizing to continue to negatively affect occupancy rates and result in additional downward pressure on rental rates. To date, wholesalers, discounters and grocers providing basic goods and services continue to be among the best positioned tenants to weather the economic downturn. As financing options remain minimal and downward pressure on commercial real estate valuations continues to mount, we expect further fundamental deterioration ahead.

There is approximately \$550 billion of commercial mortgages scheduled to mature in the next two years³ and, with limited credit, the refinancing challenge remains. Commercial mortgage originations continued to decline during the first half of 2009 while capitalization rates ("cap rates") marched higher. To date, 56% of fixed-rate securitized loans maturing in 2009 have paid-off, as shown in Chart 1.⁴ Generally speaking, we expect cap rates to continue to

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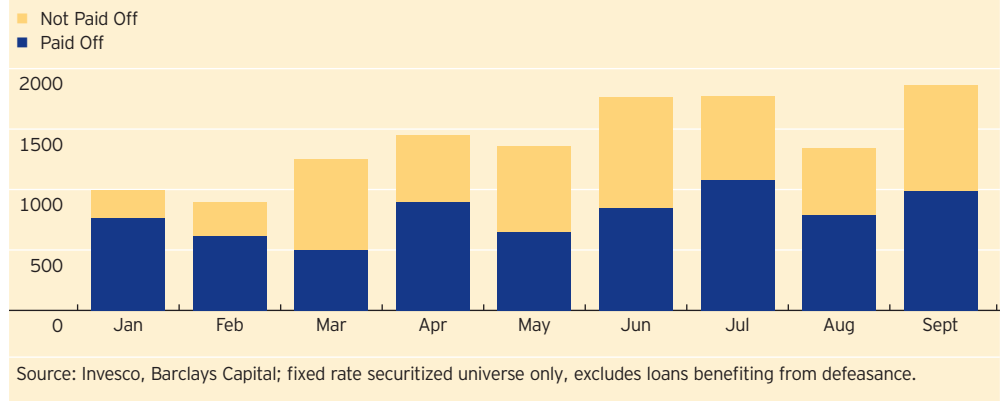
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1 Source: CBRE Econometric Advisors (formerly CBRE Torto Wheaton Research)
2 Source: TREPP, LLC; securitized universe
3 Source: Marcus & Millichap Research Services

increase, particularly those for properties in tertiary markets. As a result, loans secured by properties in stronger markets with relatively lower leverage, stronger cash flows and financially sound tenants are expected to be among the best positioned to find funding upon maturity.

Chart 1: 2009 Maturing CMBS Loans



Due to our expectation for a lack of funding in the near-term, we anticipate significant loan extensions and, in many instances, defaults. As interest reserves are depleted on struggling properties, we expect the number of modifications to increase as lenders look to combat foreclosures and property sponsors are forced to renegotiate terms. Until recently, we expected the most proactive modifications to be made to unsecuritized loans. However, related tax rules were eased this September, making it easier for servicers to proactively consider modifications to securitized loans that are at risk of default without triggering tax penalties. Borrowers whose loans are securitized will no longer have to wait until a default is imminent to begin discussions with servicers.

Real estate sales volume for the first half of 2009 was down approximately 90% from its peak in the first half of 2007.¹ The relatively minimal number of transactions over the past year has hindered valuation transparency. As more distressed sales allow for price discovery, we expect investors to have an easier time establishing values for stabilized properties.

To date, later originations containing loans with relatively higher loan-to-value ratios, lower debt service coverage ratios and pro-forma underwriting continue to post the worst performance as the number of securitized loans transferred to special servicing continues to accelerate. As of September 2009, CMBS delinquencies totaled 4.31%. Multifamily is the worst-performing sector at 7.05% and lodging is rapidly climbing, reaching 6.71%.² The nation's primary hotel markets have witnessed a greater than 13% decline in revenue per available room (RevPAR) over the last year, while occupancy rates for both full- and limited-service hotels are now at their post-9/11 lows.³ Despite benefiting from longer term leases, deterioration is expected to continue in the office, retail and industrial sectors as well. On a positive note from a supply perspective, today's relatively tight markets are better suited to combat these negative trends relative to the real estate downturn of the early '90s.

Despite our negative fundamental outlook, we believe select senior AAA CMBS benefit from substantial credit enhancement and offer attractive relative value. As fundamentals deteriorate, CMBS and commercial real estate loans must be prudently selected and predominantly secured by well-located and fundamentally sound underlying real estate. Although we anticipate continued price volatility over the near term, we expect select senior CMBS to lead in the recovery as investors use careful security selection to capitalize on the market dislocation and the opportunity to enhance returns via TALF leverage.

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1 Case-Shiller® and Case-Shiller Indexes® are registered trademarks of Fiserv, Inc. The S&P/Case-Shiller Home Price Indexes measure the residential housing market, tracking changes in the value of the residential real estate market in 20 metropolitan regions across the United States. These indexes use the repeat sales pricing technique to measure housing markets. First developed by Karl Case and Robert Shiller, this methodology collects data on single-family home re-sales, capturing re-sold sale prices to form sale pairs. This index family consists of 20 regional indexes and two composite indexes as aggregates of the regions

The S&P/Case-Shiller Home Price Indexes are calculated monthly and published with a two-month lag. New index levels are released at 9 a.m. Eastern Time on the last Tuesday of every month. In addition, the S&P/Case-Shiller U.S. National Home Price Index is a broader composite of single-family home price indexes for the nine U.S. Census divisions and is calculated quarterly.

Index Governance and Policy: This index is maintained by an Index Committee, whose members include Standard & Poor's, Fiserv and leading industry experts. It follows a set of published guidelines and policies that provide the transparent methodologies used to maintain the index.

2 LoanPerformance HPI is produced by First American Core Logic and covers 10 mortgage tiers with full history every month using national repeat-sales transaction data.

3 Data reported by the National Association of Realtors on Bloomberg.

4 Data reported by the National Association of Realtors on Bloomberg.

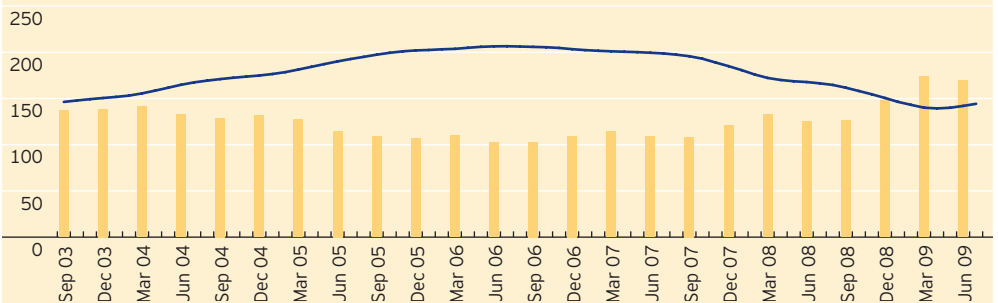
5 Alt-A mortgages, short for Alternative A-paper, are a category of mortgages which have a risk potential that is greater than A-paper, or "prime", mortgages but less than subprime. The interest rates offered on these mortgages are usually between the prime and subprime levels. The reason for the increased risk is usually not the borrower's credit history, but rather something specific about the mortgage, such as less than full documentation by the borrower, higher loan-to-values, and non-owner occupied, investment properties. Subprime mortgages are used by borrowers with low credit ratings. Borrowers who use subprime loans generally do not qualify for loans with lower rates because they have damaged credit or no credit history, and are thus considered risky by lending agencies. Because the default risk for poor credit borrowers is greater than of other borrowers, lenders charge a higher interest rate on subprime loans.

Residential Mortgage Market Commentary

Recent months have provided evidence of a shift in residential mortgage market fundamentals. The factor receiving the most attention has been a reprieve from home price depreciation. As shown in Chart 2, the S&P/Case-Shiller 20-City Composite Home Price Index¹ turned positive over the spring and continued gains through the summer, marking the first quarterly rise in three years. The LoanPerformance HPI² has posted positive annualized one-month home price appreciation every month since May. While some areas still saw continued declines, those composing a large percentage of nonagency geographic exposures (California and Florida) also turned positive. Existing home sales data was also positive with seasonally adjusted sales climbing 7.2% to a 5.24 million annual rate in July before declining 2.7% in August to a 5.10 million annual rate.³

Chart 2: Housing Affordability

■ National Association of Realtors Housing Affordability Composite Index
■ S&P/Case-Shiller Composite - 20 Home Price Index



Source: Bloomberg

Improvements in prices also carried over to housing inventory. After peaking at 11.3 months supply in April 2008, the inventory of homes for sale fell through August to an 8.5-month supply. Driving the improvement was a 3.60 million (11.0%) drop in the number of unsold homes on the market.⁴

The seasonal sales effect was especially strong this summer as a result of several factors. An increase in the portion of transactions involving distressed properties in late 2008 and early 2009 negatively impacted average sale prices, setting the stage for price improvement when nondistressed transactions increased in the spring and summer months. Also, continued agency mortgage-backed securities (MBS) purchases by the U.S. Federal Reserve (Fed) have driven mortgage rates to all time lows, adding a sense of urgency for those who are considering purchasing a home. Finally, we believe the first-time homebuyer tax credit has provided an added boost, and likely shifted some demand forward to the summer buying season.

There has also been a dramatic reversal in current to 30-day delinquent transition rates for subprime, with the same trend developing in Alt-A and prime sectors.⁵ Also, loss severities - or the costs to foreclose and liquidate a home securing a defaulted mortgage, as well as any decline in property value - in subprime have begun to level off. While Alt-A and prime collateral have lagged this improvement, it appears severities in these sectors have begun to moderate.

We do not expect this recent strength to be sustained as we look ahead to the fall and winter months. The first-time homebuyer tax credit will expire in November unless extended. Dispositions of foreclosed properties are not keeping pace with new loans entering foreclosure, and the recent improvement in available supply may reverse as servicers are forced to become more aggressive. Additionally, Fed purchases of agency MBS will wind down by the end of the first quarter of 2010, and will likely result in higher mortgage rates as private demand for MBS is forced to absorb new originations. Lastly, another wave of defaults is likely around the corner as many borrowers with interest-only loans and option adjustable rate mortgages (ARMs) see their monthly payments increase.

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Despite our lack of confidence in the continued improvement of housing fundamentals in the near term, we believe there are still attractive opportunities within nonagency MBS. Investors should focus on seeking downside return protection and attractive return profiles that can withstand a continued deterioration in the housing market. We continue to see most nonagency MBS trading below our estimate of fundamental value and offering attractive risk-adjusted returns. While we expect further challenges ahead for the housing market, we believe that additional fundamental deterioration is largely priced in and that the demand created by the Public Private Investment Program (PPIP) will continue to support valuations in this sector.