



**Smith Graham & Co.**  
**Investment Advisors, L.P.**



**Cyril M. Theccanat**  
Executive Vice President  
Managing Director – Fixed Income

## **Fixed Income Markets Review and Outlook Second Quarter 2005**

### **Treasury Yield Curve**

The second quarter of 2005 ended with the Federal Reserve raising the Federal Funds Rate for the ninth consecutive time by 25 bp to 3.25%. This marks the one-year anniversary since the Central Bank embarked on its current tightening policy. During the current tightening cycle, the Federal Funds Rate has been increased by a cumulative 225 bp. In the second quarter, yields declined and partially reversed the rise seen in the first quarter of the year. The 2-year Treasury note's yield declined by 14 bp to 3.63%. Longer maturity securities experienced a sharper decline in yield as core inflation remained subdued. The 30-year Treasury bond's yield dropped by 56 bp to 4.19%. As a result, the Treasury yield curve flattened further by 42 bp during the quarter as the 2-year/30-year spread narrowed to 56 bp.

### **Fixed Income Sectors**

The credit sector continued to experience the negative fallout from the ratings agencies downgrades of Ford and General Motors. For the second quarter, the credit sector posted a negative excess return of -36 bp. Year-to-date, the sector's excess return stands at -91 bp. Increased volatility caused the credit quality curve to steepen by 10 bp as the single-A rated sector outperformed the BBB-rated sector. Long maturity credits lagged their short and intermediate counterparts. Consequently, the credit curve steepened by 12 bp. Within the credit sector, the finance sector was a safe haven and spreads widened by only 2 bp. Tighter swap spreads enabled the securitized sectors to outperform Treasuries. Despite the large new-issue supply in the asset-backed (ABS) market, the ABS sector posted 20 bp in excess return. In the commercial mortgage-backed (CMBS) market, the AAA-rated tranches outperformed Treasuries by 21 bp. However, the mezzanine classes underperformed on concerns over underwriting trends. The AA-rated class, for example, had a -20 bp excess return. This resulted in a steepening of the CMBS credit curve. The residential mortgage backed (MBS) market continued to outperform in the second quarter as strong reinvestment demand provided support for the mortgage basis. Despite higher realized volatility, the sector outperformed Treasuries by 8 bp. Discount coupons were the best performers driven by strong down-in-coupon flows. The reach for yield, especially at the front end of the yield curve, provided a bid for the Government Agency sector, which tightened in spread by 2 bp.

Continued >

## **Outlook**

The strength in the housing market continues to fuel economic growth in the United States by keeping consumer spending buoyant. Low mortgage rates have driven both existing home sales and new home sales to record levels. Prices have also risen sharply, thereby, increasing the equity that homeowners have been able to draw on. The Conference Board's latest reading on business confidence also shows that companies remain upbeat. Employment growth is also likely to pick up from its recent sluggish levels. Weekly jobless claims near 5-year lows are indicative of monthly employment gains in the 200,000 area. Although the broadest measure of labor costs, the employment cost index, rose by 3.5% year-over-year in the first quarter of 2005, the large increase in the pool of low-cost labor worldwide will continue to put downward pressure on labor costs. Declining labor costs and productivity gains will contribute to disinflation which will, in turn, offset the effects of higher energy and commodity prices.

While the Eurozone remains mired in slow growth, the prospects for Japan have improved. The growth in the Japanese economy has historically been driven primarily by exports. The recent weakness in this sector has been offset by rising domestic consumption. Japan's unemployment rate remains at a six-year low of 4.4%. The twin deficits in the United States continue to be an overhang on the dollar. The current account deficit is now over 6% of GDP. However, positive and widening interest rate differentials, a stronger economy and trade surpluses being produced in Asia and in the Middle East which are being primarily invested in dollar-based assets continue to underpin the U.S. currency.

Despite the 225 bp increase in short-term rates, the Federal Reserve has indicated that interest rates are still accommodative, and that the measured pace of tightening will continue. We believe that GDP growth of 2% to 3% in the second half of 2005 is likely to cap the Federal Funds Rate below 4%. The 2-year/30-year Treasury yield curve flattened 120 bp in the first half of 2005 following a 150 bp flattening in 2004. At this point, the pace of flattening is likely to slow significantly. Therefore, yield give-ups in portfolios with barbell structures need to be closely monitored. Credit spreads remain near the tight of their historical range. The richness of the sector is reflected in the sharp increase in the private acquisitions of public companies through leveraged buyouts. Event risk has clearly risen. In this environment, high quality commercial mortgage backed securities (CMBS) are more compelling on a relative value basis especially compared to lower-rated credits trading at tighter spreads. The current low level of Treasury yields and high volatility make the mortgage-backed (MBS) sector attractive. The Treasury Inflation Protected Securities (TIPS) sector has cheapened fairly significantly this year. Break-even spreads have declined by over 50 bp to the 2.3% area in the intermediate part of the real curve.