



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

Fixed Income and Equity Markets Review and Outlook Third Quarter 2005



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Fixed Income Markets

Interest rates reversed course and moved sharply higher in the third quarter of 2005. Despite the tragic consequences of the hurricanes in the U.S. Gulf Coast region, economic growth has maintained a firm tone. As a result, the Federal Reserve raised the federal funds rate two more times to 3.75%. This marks the eleventh consecutive increase in the funds rate since June 2004. While interest rates rose across the curve, shorter maturities experienced a greater increase. The yield on the 2-year Treasury note increased by 53 bp to 4.17%, while the 30-year Treasury bond's yield rose by 38 bp to 4.57%. Consequently, the Treasury yield curve flattened for the eighth consecutive quarter as the 2-year/30-year spread narrowed by 15 bp to end the quarter at 40 bp, a 4 ½ year low.

After a difficult first half of the year with an underperformance of 91 bp, the credit sector rebounded in the third quarter as spreads narrowed by 13 bp on better than expected earnings and stronger balance sheets. The narrowing in credit spreads generated an excess return of 30 bp for the sector. The credit quality curve flattened by 25 bp as the BBB-rated sector outperformed the single-A sector. The credit curve, however, continued to steepen as intermediate maturities outperformed longer-dated issues by 13 bp in excess return. Higher yields and a widening in swap spreads weighed on the mortgage-backed (MBS) sector which posted –24 bp in excess return for the quarter. Despite the flattening in the Treasury yield curve, 15-year passthroughs outperformed their 30-year counterparts by 19 bp. Demand for high-quality, short-maturity securities provided a bid for the asset-backed (ABS) sector. Both credit card and auto ABS outperformed similar duration Treasuries by 13 bp and 7 bp respectively during the third quarter. Increased supply in the commercial mortgage market (CMBS) pressured spreads wider, particularly for intermediate and long maturities. The overall CMBS sector posted excess returns of –6 bp for the quarter. The Government Agency curve experienced a fairly pronounced flattening as long-dated securities outperformed intermediate issues by 35 bp in excess return.

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U.S. Equity Markets

The S&P 500 index had its strongest third quarter since 1997 as all major domestic equity indices were positive during the period. The S&P 500's 3rd quarter gain of 3.6% left it in positive territory for the year at 2.8%. Despite gaining 4.8% during the quarter, the NASDAQ composite remained negative for 2005 with a loss of just under 1%. The Dow Jones Industrial's gain of 3.4% for the quarter raised it to roughly breakeven for the year. Continued strong earnings drove equity market performance as companies adjusted to higher energy costs as well as to higher short term interest rates. Small and mid cap stocks outperformed large cap stocks with gains of 5.4% and 4.9%, respectively. Year-to-date, mid cap stocks have gained 9% while small caps have followed closely behind by advancing 7.3%. Per the Russell style indexes, growth performed essentially in line with value during the third quarter, while value stocks maintained their relative performance advantage of 350 basis points for the year.

Oil prices, which spiked during August hurricane concerns with a move over \$70, retreated to \$66 as the quarter came to a close. Not surprisingly, energy-related stocks outperformed dramatically during the period continuing a year-long trend. The utilities, technology, and consumer staples sectors also turned in strong performances. At the same time, companies within the consumer discretionary sector lost ground as consumers began to feel the effects of both higher energy costs and higher short term rates. Financials, particularly thrifts and mortgage companies, also lagged the broad market as the Fed continued to raise rates at a measured pace. Strong industry groups included refiners, diversified metals, steel, biotech, and internet retailers. Each of these groups advanced at least 25% during the third quarter. On the downside, banks, education services, health care facilities, and a variety of leisure industries fell 10% or more.

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Outlook

Consumer spending has been a major contributor to the strong economic growth seen in the U.S. over the past 2 ½ years. This spending, in turn, has been driven by the strength in the housing market which has enabled homeowners and real estate investors to utilize the significant build-up in equity that has resulted from the 50+% appreciation in home prices over the past 5 years. Sharply higher energy prices and higher borrowing costs, however, are beginning to curb consumption. Gasoline prices have increased by more than 50% over the past year, while natural gas prices are up a staggering 140% as we head into the winter season. More than half of U.S. households utilize natural gas for home heating. Consumer confidence has already dropped to a 5-year low. While headline inflation is set to rise in the near-term, factors such as global competition and technology are likely to be counterbalancing forces over the longer term.

Federal Reserve officials have clearly indicated that the central bank intends to keep raising short-term interest rates in a measured manner because monetary policy is viewed as still being accommodative, and in order to keep inflation under control. The financial markets are currently discounting a federal funds rate of 4.25% by year-end. GDP growth is likely to slow down to the 3% area in 2006. This would imply that we are near the tail-end of the current credit tightening cycle. In the fixed income market, risk/reward profiles are becoming less favorable for portfolios with bar-bell structures. Credit spreads remain rich while there is greater risk in this sector as companies use the cash that has been built-up on their balance sheets for bondholder unfriendly actions such as acquisitions, stock buybacks and higher dividend payouts. Securities in the high-quality securitized sectors provide better relative value opportunities. Higher Treasury yields and volatility that remains high make the mortgage-backed sector attractive. The narrowing in break-even spreads has cheapened the Treasury Inflation Protected Securities (TIPS) sector. Further supply-induced cheapening could provide buying opportunities.

In the equity markets, earnings expectations have returned to optimistic levels after surprisingly strong second quarter earnings. This optimism, combined with the potential effects of energy and higher interest rates on the consumer, could lead to higher than average earnings disappointments as companies are unable to produce results in line with Wall Street predictions. Earnings shortfalls, persistently high energy costs, inflation concerns, and housing values at historic highs relative to personal disposable income, will make it very difficult for equity markets to advance during the traditionally strong fourth quarter. Also, equity markets, including the broad S&P 500 index, have advanced nearly 60% since the fourth quarter of 2002. After hitting new cyclical highs during August 2005, a healthy consolidation may be required as the Federal Reserve winds down its tightening campaign in the coming months.