

Markets Review and Outlook Fourth Quarter 2005

Fixed Income Markets

Treasury yields rose for a second consecutive quarter as the U.S. economy rebounded from the after-effects of the hurricane-induced slowdown earlier in the quarter. The continued expansion in economic activity together with the potential for higher inflation from increased resource utilization moved the Federal Reserve to raise short-term interest rates by 25 bp two more times in the final quarter of 2005. These actions brought the federal funds to 4.25% by year-end. Since the start of the current credit tightening cycle in June 2004, the federal funds rate has been increased by a cumulative 325 bp. By the end of the fourth quarter, the yield on the 2-year Treasury note had increased by 23 bp to 4.4%. The Treasury yield curve inside 10 years inverted with the 5-year Treasury note, for example, yielding 4.35%, 5 bp **less** than the 2-year Treasury note's yield. Long maturity yields maintained a firm tone, as core inflation remained relatively low. The yield on the 30-year Treasury bond **decreased** by 3 bp to 4.54%. As a result, the Treasury yield curve flattened further with the 2-year/30-year spread narrowing by 26 bp to end the quarter at 14 bp.

All major fixed income sectors underperformed Treasuries in the fourth quarter of 2005. The credit sector was negatively impacted by the continuation of ratings agencies downgrades in the auto sector, and by the increase in event risk in other sectors such as information technology, publishing, paper and forest products. The overall credit sector underperformed Treasuries by 25 bp. This underperformance was led by the industrial sector, which posted an excess return of -58 bp. The finance sector held up relatively better as bank and broker spreads widened by 6 to 7 bp. While the credit quality curve steepened as the single-A rated credit sector outperformed the BBB-sector by 13 bp, demand for long corporate securities helped narrow the corporate credit curve by 9 bp. The Government Agency sector lagged Treasuries as spreads widened by 6 bp. In the securitized sectors, the widening in swap spreads contributed to the underperformance of the asset-backed (ABS) and commercial mortgage-backed (CMBS) sectors, which posted excess returns of -13 bp and -14 bp respectively for the quarter. The residential mortgage-backed (MBS) sector was additionally hurt by higher realized volatility. Within this sector, reduced issuance enabled GNMA-backed collateral to outperform conventionals by 12 bp on an option-adjusted spread (OAS) basis. Discount coupons benefited from the flattening in the Treasury yield curve and outperformed premiums by 7 bp in OAS.

U.S. Equity Markets

Despite a positive 4th quarter in which the major indexes each gained at least 2%, domestic equity markets finished 2005 with gains that significantly lagged historical averages. The S&P 500 led large cap indexes with a total return of just under 5% for the year, while the Nasdaq's return of 2% was its smallest annual change since its creation in 1971. The Dow Jones Industrials Average gained less than 2% on a total return basis but actually finished lower for the year when only price appreciation is considered. Mid caps continued to dominate the market with a 4th quarter gain of 3.4% leading to a return of 12.6% for the year. Small caps also outperformed large caps with an annual advance of nearly 8% despite underperforming during the 4th quarter. Although growth stocks significantly outperformed value stocks during the quarter, value still outperformed growth by over 180 basis points during 2005 driven largely by value dominance during the 1st quarter of the year. Recent trends have shown a bias toward growth stocks, although not as dramatic as the longer-term value trend in place since 2000.

Materials, financials and industrials were the top economic sectors during the 4th quarter as markets responded to stabilizing energy prices, increased M&A activity, and continued strength in the economy. Commodities, including aluminum, paper, steel, gold, and other metals, were among the top performing industry groups and led the materials sector to a gain of more than 7%. Strength in the financials sector was broad-based and included investment banks and diversified financial services.

Energy stocks were the top performers during 2005, despite being the worst performing sector during the 4th quarter. Crude futures closed the year back over \$60 per barrel representing a calendar year gain of over 40%. Not surprisingly, the sector responded with record profits and increased M&A activity as energy companies attempted to deploy high cash levels. The worst performing sectors during the year were consumer discretionary and transportation as both areas were directly impacted by higher oil prices.

Outlook

As 2006 unfolds, the financial markets are approaching a crossroads. The quadrupling of the federal funds rate over the past 1 ½ years has brought the Federal Reserve closer to the end of its credit tightening cycle. Alan Greenspan's stellar 18 years at the helm of the Federal Reserve will end in January, and the markets will have to contend with a new chairman, Ben Bernanke. The strong housing market, which has been a major driver of the economic expansion over the past 4 years through consumer spending of mortgage equity withdrawals, is showing the beginning signs of a weakening trend. At the same time, total household mortgage debt is over \$8 trillion, which is almost double the level in 2000. Close to half of this amount is floating rate debt. So, households could be faced with rising debt payments in a slowing housing market. A retrenchment in consumer spending may be offset to some degree by capital spending which has been growing at a rate of 11% for more than a year as U.S. companies spend some of the record amount of cash that has been amassed over the past few years. However, the need to shore up pension plans and the use of cash for mergers and acquisitions may dampen the growth in capital spending. The repatriation of profits by U.S. companies to take advantage of a special one-year tax break helped the U.S. dollar index strengthen by 12.6% in 2005. However, the rising current account deficit and the federal budget deficit together with an expected narrowing in interest rate differentials are likely to put pressure on the U.S. dollar in 2006.

GDP growth is likely to decelerate to a 3% or lower rate in 2006. With core inflation expected to remain contained by global competition and technology, the federal funds rate is likely to be capped in the 4.5% area. While this environment may not be favorable for fixed income portfolios with bar-bell structures, there are several factors that will continue to underpin the long end of the yield curve including demand for long maturity securities from pension plans as the population ages, foreign buying and subdued inflation expectations. The credit sector remains expensive despite the 15 bp widening in spreads during 2005. Event risk has risen, especially releveraging risk as companies use their cash for stock buybacks and acquisitions. Issue selection will be an important factor in 2006. In the securitized sectors, demand for high-quality, short-maturity securities will continue to provide a bid for the asset-backed sector. In the mortgage-backed sector, increasing supply in the agency fixed-rate market due to a flatter yield curve, tighter regulatory oversight on nontraditional mortgage origination and slower prepayments on adjustable-rate mortgages will weigh on the sector. As a result, program, coupon selection and seasoning will become important. The decline in both the core inflation rate and in inflation expectations has cheapened the Treasury Inflation Protected Securities (TIPS) sector. There may be tactical opportunities in this sector during 2006 due to supply and seasonal trends.

Outlook (Cont'd)

Since the middle of 2004, the stock market has been caught between strong corporate profits driven by energy and housing, and rising short-term interest rates. Now that the Federal Reserve appears to have achieved its goal of removing the accommodation that existed in the form of low rates, a key metric to watch will be whether corporate earnings beyond the energy sector will remain strong.

Although mid-term election years such as 2006 normally produce below average stock market gains, such an occurrence would result in the 3rd consecutive year of single digit returns for the S&P 500 for the first time in over 100 years. A more likely scenario would be large cap indexes such as the S&P 500 leading any market advance while small caps finally show signs of mean reversion after 6 years of outperformance. Factors that could contribute to a period of large cap leadership are improved business spending, along with the end of last year's dollar rally, which would help multinationals. This would also be consistent in the event of an economic slowdown as small caps tend to be more economically sensitive than large caps. Meanwhile, larger companies are typically in a better position to sustain earnings growth during slowing or difficult economic periods and could outperform as investors move toward higher quality.