

## **Investment Review and Outlook 2006 First Quarter**

### **Fixed Income Markets**

Interest rates in the U.S. rose sharply in the first quarter of 2006 as stronger than expected economic growth unfolded early in the new year. This marks the third consecutive quarter of rising yields. The Federal Reserve with its new Chairman, Ben Bernanke, at the helm, raised short-term interest rates by 25 bp two more times in the first quarter of 2006 citing the potential for inflation pressures from increases in resource utilization together with elevated prices for energy and other commodities. At the end of the quarter, the federal funds rate stood at 4.75%. In the current interest rate cycle, the funds rate has been increased 15 times by a cumulative 375 bp since June 2004. During the quarter, the yield on the 2-year Treasury note increased by 42 bp to 4.82%. Strong investor demand for the new 30-year Treasury bond which was re-issued this quarter for the first time since 2001, resulted in a further flattening in the yield curve as the 30-year bond's yield rose by 36 bp to 4.89%. By the end of the first quarter, the 2-year/30-year Treasury yield spread was 7 bp compared to 14 bp at the end of 2005.

After underperforming in the fourth quarter of 2005, all the major fixed income sectors rebounded in the first quarter of 2006. Despite a record \$236 billion in investment grade corporate bond issuance during the quarter, the credit index posted 33 bp of excess return as spreads tightened by 8 bp. Reduced investor risk-aversion was reflected in the flattening of the credit quality curve as the BBB-rated sector outperformed the single-A rated sector by 40 bp in excess return. The 2 to 4 bp decline in swap spreads contributed to the strong performance for the securitized sectors. The commercial mortgage-backed sector (CMBS) was the best performing sector with 51 bp in excess return. This was primarily the result of the significant spread tightening in the subordinated tranches. The BBB-rated CMBS sector, for example, saw spreads tighten by 37 bp for the quarter. The credit card and auto asset-backed sectors (ABS) also had good performance with excess returns of 26 bp and 17 bp respectively. The residential mortgage-backed sector (MBS) benefited from the decline in both realized and implied volatility and posted 44 bp of excess return for the quarter. Within the MBS sector, GNMA-backed securities lost ground due to their relative richness and ended the quarter underperforming conventionals by 20 bp.

### **U.S. Equity Markets**

Despite a two week slide as the first quarter came to a close, domestic equity markets recorded impressive gains during the period. The S&P 500's total return of 4.2% was its best first quarter performance since 1999 as bullish sentiment reached its highest level in 6 weeks. The Dow Jones Industrials matched the broader S&P 500's return while the Nasdaq led all three with a gain of 6.4%. Small caps led once again and were up nearly 13% while mid caps also outperformed by advancing 7.6%. Per the Russell style indexes, value stocks significantly outperformed growth during the period with a 6% return that was nearly double the 3.1% increase for growth stocks.

## **U.S. Equity Markets (Cont'd)**

Among large cap stocks year-to-date, mega-caps with low growth characteristics and low price multiples performed best. This is reflected by the leading economic sectors in the Russell 1000 index, which were producer durables, autos & transportation, and materials & processing. Each had gains of at least 9% during the quarter while the best performing industry groups within each sector reflected continued strength in the economy. Top industry groups in producer durables included machinery (construction, specialty, engines), electronics, and aerospace. All industry groups within producer durables were positive except the homebuilders, which lost over 5%. The strong autos & transportation performance was the result of double-digit gains by railroads and air transportation. In the materials & processing sector, industry groups associated with construction, including cement, steel, building materials, and engineering & contracting, posted gains as high as 50% amid continued global demand.

Integrated oil companies also returned 8.5% as crude oil futures rose 9% in the first quarter and closed at nearly \$67 per barrel. Energy companies with high exposure to natural gas did not fare as well as futures for that commodity fell 35% to close at just over \$7 per million BTU.

High-multiple sectors such as healthcare and consumer staples lagged the market and each advanced only 1%. Within healthcare, slower growth drug companies were the best performers with a gain of 4.6%, while high growth, high beta biotech stocks lost 2% during the same period. Drug & grocery stores, foods, and soft drinks were positive within staples while tobacco lost nearly 3%.

## **Outlook**

Higher borrowing costs have not yet dampened economic growth. In the U.S., labor markets remain firm and consumer confidence has turned up. Although the housing market has slowed down, housing starts and home sales are still near record levels. Companies are also ramping up capital spending plans. Globally, the American consumer has been the primary driver of world growth for the past five years. On the other hand, the second and third largest world economies, Japan and Europe, have been significant drags on global growth. This may be changing as both consumer and business spending are showing signs of picking up in these two regions. Fourth quarter GDP in Japan grew at an annualized rate of 5.4%, which is the highest among the G7 industrialized countries. Business confidence in Germany is at its highest level since the reunification boom in the early 1990's. Coupled with the strong growth in the emerging economies such as China, India and Brazil, the world could be moving to a period of synchronized global growth together with tighter monetary policies.

## **Outlook (Cont'd)**

In the U.S., the Federal Reserve has indicated that it will remain in a credit tightening mode to prevent increased resource utilization and higher commodity prices from adding to inflation pressures. Despite the near quadrupling of short-term interest rates, borrowing costs do not appear to be restrictive enough. As a result, the Federal Reserve's credit tightening cycle may not be near its end. The federal funds rate is likely to cap out in the 6% area.

The corporate bond sector remains expensive as spreads are still tight and do not compensate investors for the increased level of risk. In the first quarter of 2006, there were \$26 billion in leveraged buyout and private equity transactions. This level was greater than the total value of such transactions for the entire year of 2004. Issue selection is becoming a critical factor in the corporate bond sector. High quality commercial mortgage-backed securities remain a compelling alternative. 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.

As the first quarter came to a close, profit expectations rose to over 10% from 9% just a month earlier. This would mark the 15<sup>th</sup> consecutive quarter of double-digit profit growth. Markets also received a boost from heightened merger activity as deals valued at \$885 billion were announced. This is 50% above the same period last year and was the busiest 1<sup>st</sup> quarter since 2000. Leaders in transports and durables, along with stellar profit growth, also point to continuing strength in the economy. This strength has allowed many industries to adjust to oil prices in the \$60 dollar range, as well as to the effects of the ongoing rate hike cycle.

Although healthcare and consumer staples were the lagging sectors, markets still reflected defensive characteristics as lower-growth, beaten down megacaps were the best performers among large cap stocks. Additionally, despite the impressive advance in the equity markets during the period, investor sentiment was notable in that it remained in a neutral range throughout the quarter and rarely gave clear buy or sell signals per Ned Davis Research. The second and third quarters of a Presidential mid-term election year are typically difficult ones for equity markets. When combined with slowing earnings growth, passive investor sentiment, and an uncertain end to the rate hike cycle, the equity market will likely have a difficult time improving on its 1<sup>st</sup> quarter performance in the near term.