

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

### **Fixed Income Markets**

Interest rates continued to climb higher in the second quarter of 2006 as the Federal Reserve raised the federal funds rate two more times to 5.25% citing strong economic growth and higher inflationary pressures. This marks the longest consecutive stretch of interest rate increases over a two-year period since the 1950s. During the second quarter, interest rates rose across the curve with the yield on the 2-year Treasury note increasing by 33 bp to 5.15%, while the yield on the 30-year Treasury bond rose by 30 bp to 5.19%. Although the Treasury yield curve flattened during the quarter by just 3 bp, with the 2-year/30-year Treasury spread narrowing from 7 bp to 4 bp, curve volatility was present as seen in the 23 bp steepening in April and the 27 bp flattening in May and June combined.

Increased volatility in the stock market and the sharp downturn in stock prices pressured corporate bond spreads during the second quarter. As a result, the credit sector posted -19 bp of excess return. Risk-aversion was reflected in the steepening of the credit quality curve as the single-A rated sector outperformed the BBB-rated sector by 7 bp in excess return. The overall credit curve also steepened as long maturity securities underperformed intermediate issues by 53 bp. Within the credit sector, underperforming sectors include energy, insurance, sovereign, health-care and home construction. Defensive sectors outperformed producing positive excess returns. These include media, entertainment, food & beverage and transportation. The securitized sectors underperformed Treasuries as swap spreads widened by 2 to 6 bp. The mortgage-backed sector (MBS) lagged by 13 bp. Within the MBS sector, GNMA-backed securities continued to lose ground for a second consecutive quarter due to lack of foreign buying. GNMA 30-year securities underperformed their conventional counterparts by 51 bp in excess return. Despite the flattening in the Treasury yield curve, limited supply enabled 15-year passthroughs to post 3 bp in excess return and outperform 30-year mortgages by 15 bp. The asset-backed sector (ABS) was relatively in-line with Treasuries, with the exception of the auto-backed sector which posted 9 bp of excess return. Following the strong performance in the first quarter of the year, profit-taking and increased supply weighed on the commercial mortgage-backed (CMBS) sector which had -7 bp of excess return for the second quarter.

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

Despite the biggest single day rally since 2003, induced by statements from the Federal Reserve, broad equity markets were down during the second quarter. Of the major indexes, only the Dow Jones Industrials, made up of 30 blue chip stocks and driven by a 40% gain in General Motors, posted a gain during the period and advanced 1%. The S&P 500 lost 1.4% while the Nasdaq Composite lost 7%, as investors moved away from higher risk stocks in anticipation of an economic slowdown. On a total return basis, the Dow is up over 5% so far in 2006, while the S&P 500 is up less than 3%. The Nasdaq remains in negative territory and is now down 1% for the year. Although small caps were the biggest losers during the second quarter and were off 4.5%, they remain the best performer year to date with a gain of nearly 8%.

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

Value stocks continued to dramatically outperform growth stocks, widening the gap to nearly 800 basis points through June 2006. Growth stocks have lost nearly 1% so far this year.

Energy companies were the best performers during the second quarter, led by coal, gas pipelines, integrated oils, and oil well services. The move reflected an 11% rise in crude oil futures during the period as geopolitical issues and global demand drove prices. Utilities of all types also performed well as cable companies rebounded, along with gas distributors and electrical utilities. Autos & transportation's quarterly gain of 3% helped it move into a virtual tie with integrated oils as the top performing economic sector year-to-date. Both sectors have gained 13%. Railroads, auto, and transport companies led the advance within the autos & transportation sector. Consumer staples also outperformed the broad market during the second quarter as brewers, tobacco and soft drinks found buyers.

Technology (-10%) was easily the worst performing sector for the quarter and is now down nearly 5% year to date. Communications technology companies were down 13%, while computer technology, software, and semiconductors were each off 9% or more. Healthcare and multi-sector companies lost 4.7% and 3.1%, respectively as neither sector demonstrated defensive characteristics during the second quarter selloff. Technology and healthcare, down 3.6% so far this year, reflected the move away from high growth and high multiple areas of the market.

## **Outlook**

While the U.S. economy has remained fairly resilient in the face of higher interest rates and sharply higher energy costs, there are increasing signs that growth is moderating. The construction and manufacturing sectors are weakening. After having more than doubled over the last 10 years, and increasing 11.2% in 2005, residential construction in the first 5 months of 2006 has declined at a 5.2% annual rate. While the purchasing managers index is still over 50, reflecting expansion in the manufacturing sector, it is well off the robust 63 level reached in April 2004. Furthermore, the employment component of this index dropped below 50 in June, ending the month at 48.7. On the inflation front, higher energy and commodity prices have kept the annual increase in the overall consumer price index above 3% since mid-2004. However, global competition, increased productivity and technological innovations have kept the core inflation rate between 2% and 2.5% over the past 2 years. With growth moderating and core inflation contained, the Federal Reserve is most likely near the tail-end of its credit tightening phase.

Although interest rate differentials currently favor the U.S. dollar, slowing economic growth together with growing budget and trade imbalances will weigh on the dollar. Strong credit fundamentals have supported corporate bond spreads for over 2 years. However, spreads are likely to come under pressure due to heightened event risk from increased merger and leveraged buyout activities. Issue selection is, therefore, becoming an increasingly important factor. High-quality commercial mortgage-backed securities are a compelling alternative. While higher yields have made the MBS sector attractive, slowing turnover from a slowdown in housing make program, coupon selection and seasoning important factors to consider.

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

Interest rate concerns, geopolitical issues associated with Iran and North Korea, and a potential economic slowdown, have all combined to cause market uncertainty at a time when corporate earnings growth has remained in double digits for 15 straight quarters. Equity market gains have been disappointing despite strong profit growth and as a result, market valuations have drifted lower. Although markets are likely to remain in an overall trading range leading up to the mid-term elections in November, equity markets are poised to rally on any positive interpretation associated with the end of the current rate hike cycle. This was clearly demonstrated in late June as the market staged a significant rally following the release of Fed statements that appeared to imply that further rate hikes may not be a given. Other factors that may allow a more sustained market advance prior to November include lower or stabilizing energy prices, signs that inflation is contained, continued strong earnings, or the easing of overall geopolitical concerns. Otherwise, we can expect intermediate rallies that will likely be insufficient to start a new bull market.