

Investment Review and Outlook 2006 Third Quarter

Fixed Income Markets

After a two year period of rising interest rates, the bond market reversed course in the third quarter following the Federal Reserve's decision to hold interest rates steady for the first time in the current monetary tightening cycle. Led by a continued slowdown in the residential housing market and in automobile sales, incoming economic data were largely weaker than expected throughout the quarter. Citing continued moderation in economic growth from its strong pace earlier in the year, the Federal Reserve took no action on interest rates at its meetings in the third quarter. As a result, interest rates declined across the curve with the yield on the 2-year Treasury note decreasing by 46 bp to 4.68%, while the yield on the 30-year Treasury bond declined by 42 bp to 4.76%. The Treasury yield curve steepened by 4 bp with the 2-year/30-year Treasury spread widening to 8 bp.

All fixed income spread sectors outperformed Treasuries in the third quarter as the markets responded favorably to declining interest rates, the sizeable drop in energy prices and the reduction in equity market volatility. Reflecting the strong performance in the equity markets, the credit sector posted its second highest quarterly excess return of 41 bp since the fourth quarter of 2004. Within the credit sector, the Yankee sector, namely Mexico, had the best excess return of 114 bp, followed by the finance, utility, and industrial sectors with excess returns of 54 bp, 48 bp, and 23 bp respectively. The corporate credit curve flattened as long maturity bonds outperformed intermediate issues by 40 bp. The credit quality curve, however, steepened as the BBB-rated sector underperformed the A-rated sector by 13 bp. In the credit sector, interest rate sensitive and defensive sectors such as banks, insurance, brokers, electric utilities, food and beverage were leading performers. Lagging sectors reflected concerns related to a slowing economy and increased event risk from leveraged buyout activity. Sectors affected include manufacturing, gaming, lodging, and airlines. The securitized sector posted 30 bp of excess return in the third quarter. The outperformance of the mortgage-backed (MBS) sector resulted from tighter swap spreads and positive carry despite higher realized volatility. Discount passthroughs were the best performers in the MBS sector while premium coupons underperformed due to negative convexity. In the 30-year program, Ginnie Maes rebounded from their dismal performance in the second quarter and posted 28 bp of excess return. The asset-backed (ABS) and commercial mortgage-backed (CMBS) sectors benefited from the 5 to 8 bp narrowing in swap spreads together with strong investor demand for high-quality securities at the short-end of the yield curve. For the quarter, these two sectors generated 31 bp and 47 bp of excess return respectively. However, the auto ABS sub-sector lagged the other ABS sectors by 15 to 20 bp as slower auto speeds and extensions on certain callable tranches negatively impacted returns.

U.S. Equity Markets

Driven by falling energy prices and stable interest rates, domestic equity markets posted strong gains during the third quarter. The S&P 500 index and the Dow Jones Industrial Average each gained over 5%, with the Dow flirting with all-time highs. The Nasdaq Composite gained as well, but was a notable laggard with an advance of only 4%. The Dow remains the top performer for the year and is up nearly 11%, while the S&P 500 has advanced more than 8%. The Nasdaq is now in positive territory but remains far behind with a gain of just over 3%. The Nasdaq's poor relative performance is reflective of the market's move toward large caps as small and mid cap stocks failed to participate in the market rally. These indexes actually lost ground during the quarter as both the S&P 400 mid cap index and the S&P 600 small cap index fell roughly 1% and now trail large cap stocks year-to-date. Although growth outperformed value during both August and September, per the Russell style indexes, value stocks continue to lead growth stocks by over 1000 bp since the beginning of 2006.

Technology was the best performing sector during the third quarter with an advance of 10%, most of which came during August. Software, computer technology, and communications were the sector leaders as semiconductors and electronics advanced, but underperformed the sector. Healthcare gained 9% as defensive drug companies experienced resurgence along with healthcare facilities companies. Other sectors which outperformed the broad Russell 1000 Index included utilities, financials, and consumer staples. Not surprisingly, energy stocks experienced significant declines along with commodity prices as coal, oil services, drillers, and crude producers combined to fall nearly 13%. Integrated oil companies fared better as lower commodity prices helped chemical production and demand. Although the autos & transportation and consumer discretionary sectors lagged during the quarter, both were leaders during September as commodity and raw material prices fell. Materials stocks also lagged as housing and construction are expected to slow along with the economy.

Outlook

The Federal Reserve's forecast from earlier this year of a slowing economy, led by housing, is being reflected in recent economic data releases. Over the past year, residential construction has declined by 5.1%. The final figures for second quarter GDP show that the economy grew at a 2.6% rate which is less than half the pace of the growth in the first quarter. The decline in residential construction and auto production is likely to reduce GDP growth by about 1.25% to 2% in the second half of 2006. The slowdown in housing is being partly offset by the strength in capital spending as new orders for non-defense capital goods continues to grow at a 10% year-over-year rate. However, there are signs that the slowdown in housing and autos is spreading to other manufacturing and non-manufacturing firms. Decelerating growth in the United States and overseas appears to have reduced inflation risks. The price of oil has fallen by about 26% from its recent peak and geopolitical tensions have eased for now. Market participants are now beginning to factor in expectations for a reduction in the federal funds rate in 2007.

Outlook (Cont'd)

Although interest rates in the U.S. have recently declined, interest rate differentials still favor the U.S. dollar. The growing budget and trade imbalances, however, 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. Despite lower yields, the MBS sector is still attractive because of the relative richness of other asset-backed spreads. Mortgages will also benefit as volatility declines from currently high levels. Program, coupon selection and seasoning remain important factors to consider. Treasury inflation protected securities (TIPS) have experienced significant cheapening due to the deceleration in the economy together with the decline in energy prices. As a result, there could be relative value opportunities in this sector later this year.

The equity markets have shown remarkable resiliency, although large cap outperformance, particularly driven by healthcare, staples, utilities and the beaten-down tech sector, reflect investors who are increasingly defensive. The fact that small and mid caps lagged and failed to participate could simply be mean reversion following a multi-year period of outperformance. However, this also implies that a large percentage of stocks were left behind, indicating that market breadth was indecisive at best. Although many point to the pause in the monetary tightening cycle as the catalyst for the move in the equity markets, a more significant catalyst was likely the dramatic drop in energy costs amid weakening demand and easing geopolitical concerns. Lower oil, natural gas, and gasoline help not only the consumer, but also industries and the overall economy. Market sentiment was thus sufficiently high to overcome seasonal tendencies which have traditionally seen September as the weakest month of the year. As large cap indexes struggle to reach new highs, overhangs such as housing, and the midterm elections remain.