

Investment Review and Outlook 2006 Fourth Quarter

Fixed Income Markets

During the last quarter of 2006, the Federal Reserve kept the federal funds unchanged at 5.25% for the second consecutive quarter citing expectations for the economy to grow at a moderate pace. As a result, interest rates increased modestly across the Treasury curve. The yield on the 2-year Treasury note rose by 13 bp to 4.81%, while the yield on the 30-year Treasury bond increased by only 5 bp to 4.81%. This resulted in the 2-year/30-year Treasury yield curve flattening by 8 bp to end the year at 0 bp.

For the second consecutive quarter all fixed income spread sectors outperformed Treasuries as the markets responded favorably to the sharp decline in energy prices, strong equity markets, and lower volatility. Reflecting the strong performance in the equity markets, the credit sector posted the highest excess return of 61 bp. Within the credit sector, the finance sector had the best excess return of 77 bp, followed by the Yankee, utility, and industrial sectors with excess returns of 65 bp, 57 bp, and 52 bp respectively. The corporate credit curve flattened as long maturity bonds outperformed intermediate issues by 40 bp, matching the third quarter's performance. The credit quality curve also flattened as the BBB-rated sector outperformed the A-rated sector by 18 bp. In the credit sector, interest rate sensitive and housing-related sectors such as banks, insurance, brokers, building materials and home construction were leading performers. Lagging sectors reflected concerns related to a slowing economy, increased event risk from leveraged buyout activity and declining energy prices. Sectors affected include energy, retailers, technology, railroads, restaurants and gaming.

The securitized sector posted 56 bp of excess return in the fourth quarter as swap spreads narrowed by 6 to 9 bp and swaptions volatility declined by 8.3%. The best performing sector with 59 bp of excess return was the mortgage-backed (MBS) sector as it benefited from lower realized volatility. Within the MBS sector, Ginnie Maes continued to lose their richness from 2005 and underperformed Conventionals by 11 bp. The 15-year passthrough sector lagged its 30-year counterpart as the yield curve flattened during the quarter. Tighter swap spreads and strong investor demand benefited the commercial mortgage-backed (CMBS) and the asset-backed (ABS) sectors. For the quarter, the CMBS sector posted 42 bp of excess return which primarily came from longer maturity tranches. The credit card and rate reduction asset-backed sectors also had good performance with excess returns of 24 bp and 28 bp respectively. The Home Equity sector posted 36 bp of excess return despite negative headline news concerning subprime lending and slower home price appreciation. The auto ABS sector lagged all other securitized sectors with an excess return of 8 bp as slower speeds and extensions on some callable tranches negatively impacted performance.

Outlook

There are increasing signs that the U.S. economy is likely to grow this year at a moderate 2% to 2.5% pace. While, the housing market downturn may not have bottomed, the rate of decline has noticeably slowed. Sturdy income growth, lower energy prices and price discounting are helping consumer confidence. The Conference Board's index of consumer confidence ended 2006 near a four-year high. Global growth may also be decoupling. In the past, a slowdown in the U.S. was typically followed with a slowdown in foreign developed and emerging markets. Now, however, manufacturing activity, for example, is growing robustly in Europe, Asia and South America while it has decelerated in the U.S. Organic demand in fast-growing countries such as China and India is helping to buoy global growth. In this environment, investors' expectations for a cut in the federal funds rate in the first quarter of 2007 may be premature. The Federal Reserve is likely to keep monetary policy on hold at least through the first half of 2007. While the central bank has repeatedly expressed concern about inflation risks that could result from the currently tight labor markets, the global supply of labor and increased competition could help to contain inflation pressures.

Annualized volatilities for stock, bond, and currency markets are still near historic lows, implying that risk taking is very high, spreads are tight, and markets are vulnerable to shocks. Strong credit fundamentals and rising demand from structured credit and foreign investors have supported tight credit spreads. Spreads are likely to come under pressure due to rising event risk from merger and leveraged buyout activities. Security selection, therefore, will remain an important factor. Balance sheets will gradually deteriorate due to increasing margin pressures in 2007. As defaults begin to rise, investment grade credits should outperform high yield securities. Credit sectors with defensive characteristics, such as telecoms, global banks, brokerage, insurance and utilities are likely to perform well.

High-quality commercial mortgage-backed securities continue to be compelling alternatives to corporates. The mortgage-backed sector is attractive because of the relative richness of other asset-backed spreads. However, program, coupon selection and seasoning are important factors to consider. Treasury inflation protected securities (TIPS) have experienced significant cheapening due to the decline in energy prices. However, negative carry does not make this sector attractive yet. In 2006, the U.S. dollar depreciated against the major currencies, except for the Japanese yen and the Canadian dollar as expectations for foreign central bank rate hikes grew. In 2007, Europe, Japan, Australia, and New Zealand are likely to see stronger growth and higher interest rates. In addition to the budget and trade deficit concerns, the negative sentiment surrounding the U.S. dollar is being driven by expectations for reductions in the federal funds rate. If these rate reductions are pushed further out into 2007, this could set the stage for an unexpected rally in the dollar.