Investment Review and Outlook
February 2007

Fixed Income Markets

Economic data released during the month of February were mixed with stronger employment, income and consumer spending but weaker durable goods orders and manufacturing activity. Global equity markets were roiled by the sharp drop in the Chinese stock market towards the end of the month. As a result of the rise in volatility and the flight to quality, the yield on the 2-year Treasury note declined by 27 bp to 4.64%, while the yield on the 30-year Treasury bond decreased by 23 bp to 4.68%. This caused the 2-year/30-year Treasury yield curve to steepen by 4 bp for the month.

Despite the decline in the equity markets, the credit sector managed to outperform Treasuries for the 8th consecutive month by 8 bp. Within the credit sector, the industrial sector had the best performance with an excess return of 21 bp, followed by the utility sector with an excess return of 17 bp. The finance sector lagged Treasuries for the second month with an excess return of -7 bp as banks and brokers underperformed due to concerns related to sub-prime mortgage lending and the significant downturn in equity markets. The corporate credit curve flattened as long maturity bonds outperformed intermediate issues by 4 bp. The credit quality curve also flattened as the BBB-rated sector outperformed the A-rated sector by 15 bp. In the credit sector, consumer cyclicals, media/cable and telecommunications were leading performers for the month. Lagging sectors included capital goods and financial institutions.

The securitized sector was negatively impacted by the 2 to 4 bp widening in swap spreads and the 10+% increase in volatility. Within the securitized sector, the mortgage-backed (MBS) sector had the worst performance with an excess return of -11 bp followed by the commercial mortgage-backed (CMBS) and the asset-backed (ABS) sectors with excess returns of -8 bp and 2 bp respectively. In the MBS sector, 15-year passthroughs outperformed the 30-year sector by 10 bp as higher volatility hurt longer duration mortgages. Within the ABS sector, autos outperformed credit cards by 4 bp. Worsening problems in the sub-prime market adversely affected the home equity sector which posted an excess return of -16 bp.

Outlook

The global financial markets experienced a sharp repricing of risk in the last few days of the month as a result of the turmoil in equity markets. Higher volatility and greater uncertainty widened swap spreads and credit spreads and steepened credit as well as quality curves. With investors becoming more risk-averse, the repricing of risk is likely to increase the cost of capital and could have an adverse effect on world economic growth.

The Federal Reserve has repeatedly expressed its concern about inflation risks that could result from the currently tight labor markets. Core inflation is still above the central bank's preferred range of 1%-2%. U.S. economic growth, however, appears to be weaker than previously estimated. Revised data show that real GDP expanded at only 2.2% in the fourth quarter 2006 compared to the initial estimate of 3.5%. Any financial crises triggered by dislocations in the capital markets will only slow future economic growth further. The federal funds futures market is now pricing in a better than even odds for a 25 bp cut in the federal funds rate to 5% by August 2007.

While strong credit fundamentals and rising demand from the creation of structured credit transactions have supported the richness in the credit sector, spreads will come under pressure from rising risk-aversion. Balance sheets will also gradually deteriorate due to increasing margin pressures and share buy-back programs in 2007. Security selection, therefore, will remain an important factor. Defensive credit sectors with improving fundamentals and stable cash flows such as cable/telecoms, pharmaceuticals, integrated energy, insurance, and utilities are likely to perform well.

The securitized sectors are likely come under pressure from rising volatility and widening swap spreads due to counterparty credit concerns in the derivatives area. However, high-quality commercial mortgage-backed securities continue to be compelling alternatives to corporates based on relative values. The mortgage-backed sector remains attractive because of the relative richness of other asset-backed sectors. Program, coupon selection and seasoning are, however, important factors to consider. Strong demand is likely to continue for the short-dated asset-backed sector as investors look for opportunities to pick up yield without sacrificing quality.

The U. S. dollar is likely to benefit from a flight to quality if global risk aversion continues. However, if the Federal Reserve were to ease monetary policy later this year, narrowing interest rate differentials would weigh on the dollar. In Japan, the central bank is likely to keep official interest rates steady at least until the mid-term elections are over by July. This stance should lessen pressure for a reversal of yen-carry trades. However, the record cheapness of the yen versus the euro is raising significant concerns in Europe because of the adverse impact the exchange rate is having on the competitiveness of Euro-zone exports.